



This is a digital copy of a book that was preserved for generations on library shelves before it was carefully scanned by Google as part of a project to make the world's books discoverable online.

It has survived long enough for the copyright to expire and the book to enter the public domain. A public domain book is one that was never subject to copyright or whose legal copyright term has expired. Whether a book is in the public domain may vary country to country. Public domain books are our gateways to the past, representing a wealth of history, culture and knowledge that's often difficult to discover.

Marks, notations and other marginalia present in the original volume will appear in this file - a reminder of this book's long journey from the publisher to a library and finally to you.

Usage guidelines

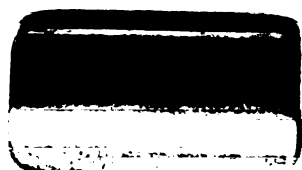
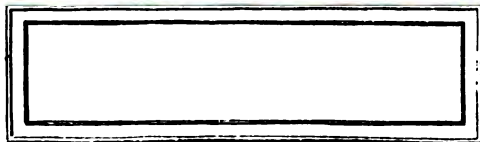
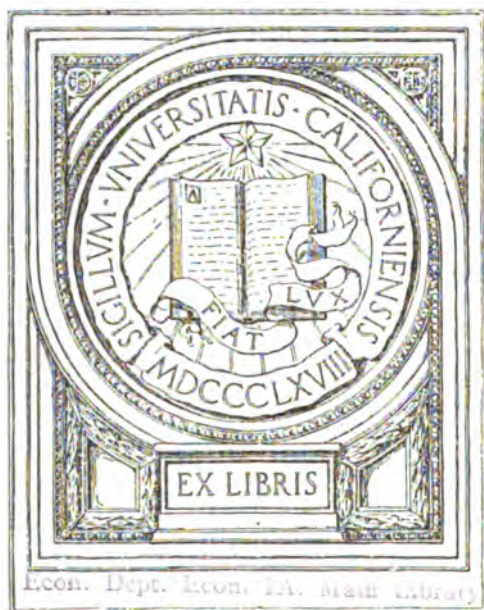
Google is proud to partner with libraries to digitize public domain materials and make them widely accessible. Public domain books belong to the public and we are merely their custodians. Nevertheless, this work is expensive, so in order to keep providing this resource, we have taken steps to prevent abuse by commercial parties, including placing technical restrictions on automated querying.

We also ask that you:

- + *Make non-commercial use of the files* We designed Google Book Search for use by individuals, and we request that you use these files for personal, non-commercial purposes.
- + *Refrain from automated querying* Do not send automated queries of any sort to Google's system: If you are conducting research on machine translation, optical character recognition or other areas where access to a large amount of text is helpful, please contact us. We encourage the use of public domain materials for these purposes and may be able to help.
- + *Maintain attribution* The Google "watermark" you see on each file is essential for informing people about this project and helping them find additional materials through Google Book Search. Please do not remove it.
- + *Keep it legal* Whatever your use, remember that you are responsible for ensuring that what you are doing is legal. Do not assume that just because we believe a book is in the public domain for users in the United States, that the work is also in the public domain for users in other countries. Whether a book is still in copyright varies from country to country, and we can't offer guidance on whether any specific use of any specific book is allowed. Please do not assume that a book's appearance in Google Book Search means it can be used in any manner anywhere in the world. Copyright infringement liability can be quite severe.

About Google Book Search

Google's mission is to organize the world's information and to make it universally accessible and useful. Google Book Search helps readers discover the world's books while helping authors and publishers reach new audiences. You can search through the full text of this book on the web at <http://books.google.com/>



The Financing of Public Service Corporations

BY

MILTON B. IGNATIUS, LL.M.

Of the New York Bar

Assistant to General Valuation Counsel, New York Central
Lines; formerly Statistician and Accountant, Public Service
Commissions of New York



UNIV. OF
CALIFORNIA

NEW YORK
THE RONALD PRESS COMPANY
1918

HE 2763

I 5

1918

Copyright, 1918, by
THE RONALD PRESS COMPANY

Econ. Dept. Econ. IA. Main Library

TO THE
LIBRARY

William G. Hewitt Press, Brooklyn, Printers
J. F. Tapley Co., New York, Binders

TO MY WIFE
WHOSE FAITH IN THIS, MY INITIAL UNDERTAKING,
HAS BEEN SUCH AN AID, THIS BOOK IS
AFFECTIONATELY INSCRIBED.

422144

PREFACE

I have written this book as the result of experience in dealing with the financing of public service corporations, gained through my work with the Public Service Commissions of New York State and also in private employment.

It has been my aim to offer in this one volume a comprehensive discussion of all the important aspects of public service corporation financing, from the inception of the enterprise and the issue of certificates of interest or indebtedness, to the expenditure of the proceeds and the permanent record thereof. I have intended it for the use of corporation officials and employees, representatives of the public engaged in the task of regulation, the bankers and brokers who are a necessary part of the financial organization, and in general for that part of the public which takes an active interest in the affairs of this most important branch of industry. In order to accomplish this purpose it has been necessary at times to dwell at length upon elementary principles and at other times to forego detailed discussion of some complicated problems. I offer the book, however, confident that these will not be considered as vital defects, since the thorough discussion of elementary principles is absolutely necessary to the placing of a proper foundation. If these principles are thoroughly understood and the possibilities of their application pointed out, the most difficult problems may be solved as they arise.

Anyone who has attempted to discuss the law of corporate finance will realize how difficult it is to avoid, on the one hand, the tedious detail of constant reference to the statutes of all the states, and, on the other hand, the inadequacy of any general statement. In my present task this difficulty has been very much greater because of the volume of public ser-

vice commission laws and decisions to be considered. In the attempt to avoid this difficulty I have very naturally limited myself to the work of the Commission with which I have been the most familiar—the Public Service Commission for the Second District of New York. There is, however, a more important reason for the careful study of the work of this Commission and of the laws under which it operates.

The State of New York adopted a policy of comprehensive regulation over public service corporations at a very early date under the guidance of Governor Charles E. Hughes, who, with high-minded purpose, appointed to office a group of Commissioners who brought to the task a notable degree of serious study, careful thought, and adequate comprehension of the nature and importance of the task upon which they embarked. Under such conditions it was but natural that this Commission, under the direction of its first Chairman, Mr. Frank W. Stevens, should at once take its place in the foremost rank of regulating commissions. I have not attempted to present a resumé of the work of this Commission; I have thought it best to quote freely from the decisions of cases with which I have been personally familiar, or those which were written by the men whose abilities and viewpoint I could personally gauge. The quotations, however, have been chosen with care to avoid all peculiarities of state and local or limited jurisdiction, while at the same time I have tried to make adequate reference to the viewpoint of other Commissions and to differences in matters of jurisdiction, so that the value of the book as a general work might not be limited. Where powers of the federal government are involved, I have referred to the Interstate Commerce Commission as well.

I have found it to be generally true that measures which are too often proclaimed to be acts of “high finance” or in abuse of the correct principles of capitalization and assignable to improper motives, were often resorted to by men who believed not only in the legality but also in the propriety and morality of their

acts; instead of being swayed by improper motives, many of them were conscientiously trying to do their duty in conserving, perpetuating, and enhancing the interests entrusted to their care. True, they sometimes erred in failing to recognize a public trust as well, but that conception has been a matter of evolution and only recently did it begin to be clearly defined. I am sure that no one reading these pages will gain the impression that I condone or defend these acts; I have not hesitated to condemn practices which are now known to be clearly improper, but if at the time of their adoption they were generally accepted as proper, I deem it a matter of justice to set forth the extenuating circumstances so that at least the question of personal motives may not befog the discussions which continuously arise. Under the driving pressure of an emergency we repeatedly do things which, viewed later in retrospect and dissociated from the emergency, we may be criticized for doing. Only those who have actually engaged in financing can adequately appreciate the difficult position of the one who must reconcile with the interests of his corporation, which must have capital at the lowest cost, the interests of the investor who places the highest price on his assistance, at the same time complying in full with statutes which are more restrictive than permissive in purpose.

Misunderstanding or incompleteness of information concerning the economics, accounting, and other incidents of corporation finance continue to be a source of trouble. In a large number of instances those in charge of the financing have limited their work to the banking and legal aspects of issuing the necessary stocks and bonds, and have not studied with equal care the methods of accounting for the proceeds and of recording other incidents. In consequence, through the absence of correlation, there are presented ambiguities which are susceptible to adverse interpretation.

Not all of the misunderstanding has been on the side of the corporations, however; in a needlessly large number of

instances the devices which have been condemned by the public were originally adopted because of unwise and improper limitations which the public itself had placed upon the expansion of desirable and necessary enterprises. Then, again, much of the friction caused by the attempt to regulate capitalization through public service commissions has been due simply to differences in viewpoint—corporation officials and bankers, on the one hand, have insisted upon “practical” considerations, while the representatives of the public, engaged as they were in laying down a system of control, had to reach fundamental principles which to the capitalist seemed theoretical. There was, of course, no basic conflict between the two viewpoints, and if each side had advanced a few steps further, they would have arrived at common ground. To point the way to this common ground is the mission of this book.

I could wish for no more opportune time than the present in which to issue this book. We are engaged in a war the most outstanding feature of which is its imperative demand for the marshalling of all economic resources, the rectification of all false foundations, and the strengthening of all insubstantial structures. To many people a book on corporation finance will seem to be far removed from the necessities of the present conflict, but is it not in reality very closely related to it, dealing, as it does, with one of its most important phases? Corporate financing has ceased to be a purely private affair. The transfer of railroad operating control to the Government of the United States was an epochal event; it necessarily brings in its train a vast number of problems, many of which are incidents of financing. The wisdom of the plans to be adopted, the instruments of finance to be used, and the apportionment of benefits and liabilities between the operators and the corporation, are all matters which must be based on thorough knowledge of the financial structure of these corporations as they now exist, and a full realization of the circum-

stances controlling, the forces regulating, and the reasons explaining, the many incidents in the financial history of these enterprises.

An extension of public regulation over industrial corporations was apparent before the beginning of the Great War. Such regulation is now rapidly expanding and it is only natural that, in the formulation of principles and practices to control the accounts and finances of these classes of corporations, reliance should be placed upon the precedents established in the public utility field. I have sought to keep this situation in mind, and while dealing primarily with public service corporations I have tried to serve those interested in industrial corporations as well.

I take this opportunity of acknowledging my debt of gratitude to Messrs. William C. Wishart, Statistician for New York Central Lines; Henry C. Hasbrouck, Chief of Division of Statistics and Accounts, New York Public Service Commission, Second District; John Bauer, Assistant Professor of Economics, Princeton University; William P. Coleman, Accountant, New York Public Service Commission, First District; and to other friends who by their advice and suggestion, and through fidelity in the wearisome task of reviewing the manuscript, have made possible the present character of this book and lent support to the confidence with which the author sends it forth.

MILTON B. IGNATIUS

New York City,
April 15, 1918

CONTENTS

Part I—Corporations and Public Regulation

CHAPTER	PAGE
I CORPORATIONS	I
§ 1. Corporations Defined	
2. Joint-Stock Associations	
3. Joint-Stock Associations Defined	
4. Classification of Corporations	
5. Stock Corporations	
6. Corporate Charters	
7. Corporate Powers	
8. The Instruments of Corporate Finance	
II PUBLIC SERVICE CORPORATIONS AND COMMISSIONS . .	14
§ 9. Public Service Corporations	
10. What Constitutes Public Service	
11. Rule as to Determination of Public Service Corporations	
12. Relationship Between Public Service Corpora- tions and the Public	
13. Regulation by Commission	
14. Public Service Commissions	
15. Federal Interstate Commerce and Trade Com- missions	

Part II—Capital Stocks

III ISSUE AND TRANSFER OF CAPITAL STOCK	31
§ 16. Capital and Capital Stock	
17. Authority for Issue of Capital Stock	
18. Par Value of Capital Stock	
19. Certificates of Stock	
20. Issue of Stock	
21. Payment for Shares of Stock	
22. Subscriptions to Capital Stock	
23. Transfer of Certificates of Stock	
24. Certificates of Stock as Negotiable Instruments	
25. Shares of Stock Taxed as Personal Property	

CHAPTER	PAGE
IV RELATION OF PAR VALUE TO PRICE OF ISSUE AND VALUE OF STOCK	54
§ 26. Capital Stock to be Issued at Par	
27. Watered Stock	
28. (1) Stock Issued for Property or Services	
29. (2) Statutory Restraints on Watering Stock	
30. (3) Effect of Watering Stock of Public Service Corporations	
31. (4) Aspects of Stock-Watering Sometimes Con- sidered Defensible	
32. Stock Issued at Discount	
33. Stock Issued at Premium	
34. Accounting for Issues of Stock at Discount or Premium	
35. Par Value in Relation to Actual Value	
36. Issue of Shares Without Par Value	
37. (1) New York Statute as to Shares Without Par Value	
38. (2) Characteristics Compared with Par Value of Shares	
V STOCKHOLDERS AND CORPORATE CONTROL	84
§ 39. Corporate Control	
40. Voting Rights	
41. Proxies	
42. Voting Trusts	
43. Majority Control	
44. Special Responsibilities of Majority Stock- holders	
45. Minority Representation	
46. Qualifications of Stockholders	
47. Stock of Corporation Held by Itself	
VI CLASSIFICATION OF CAPITAL STOCK	96
§ 48. Authority for Classification	
49. Common Stock	
50. Preferred Stock	
51. Preferment as to Assets	
52. Lien of Preferred Stock	
53. Preferment in Dividends	
54. (1) Participating and Non-participating	
55. (2) Cumulative and Non-cumulative	
56. Preferment in Control	

CONTENTS

xiii

CHAPTER

PAGE

- 57. Convertible Preferred Stock
- 58. Redeemable Preferred Stock
- 59. Special Classes of Stocks

VII DIVIDENDS 112

- § 60. Declaration of Dividends
- 61. Dividends Out of Surplus Profits
- 62. Determination of Surplus
- 63. (1) Importance of Correct Accounting
- 64. (2) Balance Sheet, Income Statement, and Profit and Loss Account
- 65. (3) Real Surplus Distinguished from Book Surplus
- 66. (4) Manipulation of Surplus
- 67. Amount of Surplus Which May Be Divided
- 68. Dividends in Relation to Wasting Assets
- 69. Stockholders' Title to, and Remedy for, Undivided Profits
- 70. Mediums of Distribution
- 71. Cash Dividends
- 72. Scrip Dividends
- 73. Bond Dividends
- 74. Stock Dividends
- 75. Property Dividends
- 76. Dates of Declaration and Payment of Dividends

Part III—Funded Debt

VIII BONDS, TRUST DEEDS, AND MORTGAGES 147

- § 77. Corporate Borrowing
- 78. "Loan-Capital"
- 79. Funded and Unfunded Debt
- 80. Corporate Bond Issues
- 81. Bonds and Notes
- 82. Bonds and Stocks
- 83. Par Value of Bonds
- 84. Security for Funded Debt
- 85. Mortgages and Deeds of Trust
- 86. Parties to, and Authority for, Execution of Trust Deed
- 87. The Bond Agreement
- 88. Parties to the Bond Agreement
- 89. Coupon and Registered Bonds

CHAPTER	PAGE
90. Property Subject to Mortgage	
91. Security Value of Property Mortgaged	
92. Control, Actual and Contingent, of Bondholders	
93. Trustees	
94. Certification of Bonds by Trustee	
95. Custody of Stocks and Bonds Pledged as Col- lateral	
96. Enforcement of Lien for the Satisfaction of Debt	
97. Reorganization	
IX CLASSIFICATION OF BONDS	185
§ 98. Bond Characteristics	
99. Mortgage Bonds Secured on Realty	
100. Mortgage Bonds Secured on Personalty	
101. Ranking Order of Liens	
102. Debts Unsecured by Mortgage or Pledge	
103. Reinforced Security	
104. Taxation of Bonds	
X BOND INTEREST AND NET YIELD	210
§ 105. Interest	
106. Payment of Bond Interest	
107. Nominal Interest Rate	
108. Effective Interest Rate	
109. Issue of Bonds at Discount or Premium	
110. Bond Values	
111. Net Dividend Yield	
112. Net Interest Yield	
113. Accounting for Premium and Discount on Bonds	
114. Interest Payable in Gold Coin or Legal Tender	
XI MATURITY, REFUNDING, AND REDEMPTION OF BONDS	228
§ 115. Permanency of Funded Debt	
116. Interminable and Extra-Long-Term Bonds	
117. Long-Term Bonds	
118. Short-Term Bonds and Notes	
119. Redeemable, Callable, and Optional Bonds	
120. Convertible Bonds	
121. Redemption of Debt Upon Maturity	
122. Amortization of Debt	
123. (1) Serial Bonds	

CONTENTS

XV

CHAPTER

PAGE

- 124. (2) Sinking Funds
- 125. (3) Effect of Serial Maturities or Sinking Fund
Accruals
- 126. (4) Equalizing Annual Burden of Amortization
- 127. (5) Sinking Fund Investments
- 128. (6) Extent to Which Sinking Funds Are Now
Used

XII RELATION OF BONDS TO STOCK 251

- § 129. Importance of Proper Proportion Between
Stocks and Bonds
- 130. (1) Earlier Tendency Toward Greater Proportion
of Bonds
- 131. (2) Earlier Tendency Correcting Itself
- 132. (3) Stockholders' Investment Should Support
Loans
- 133. Statutory Provisions Regulating Proportion
- 134. Considerations Governing Determination of
Proper Proportion
- 135. (1) Considerations of Corporate Control
- 136. (2) Adequacy and Apportionment of Earnings
- 137. (3) Relative Ease in Marketing Stocks or
Bonds

Part IV—Capitalization

XIII PUBLIC REGULATION OF STOCK AND BOND ISSUES . . 267

- § 138. Demand for Regulation
- 139. Direct and Indirect Regulation of Capitalization
- 140. Federal Regulation of Capitalization
- 141. State Regulation of Capitalization
- 142. Limitations of State Jurisdiction
- 143. (1) Jurisdiction Over Stock and Bond Issues of
Domestic Corporations
- 144. (2) Jurisdiction Over Stock and Bond Issues of
Foreign Corporations

XIV THE TASK OF PUBLIC SERVICE COMMISSIONS IN REGU- LATING CAPITALIZATION 286

- § 145. Statutory Purposes for Which Capitalization
May Be Authorized
- 146. Scope of Commission's Authority

CHAPTER	PAGE
147. (1) Application of the Statute	
148. (2) Incidents of Capitalization to Be Considered by Commission	
149. (3) Limitations upon Discretionary Powers of Commission	
150. Problem of Existing Overcapitalization	
151. (1) Extent to Which Regulation May Be Retroactive	
152. (2) Nature of Overcapitalization	
153. (3) Regulation of Accounts a Corrective Measure	
154. (4) Overcapitalization Need Not Bar Proper Stock and Bond Issues	
155. Financial Record and Status of Applicant to Be Considered	
156. Paramount Duty of Commission	
 XV COLLATERAL ASPECTS OF REGULATING STOCK AND BOND ISSUES	 308
§ 157. Control Over New Enterprises	
158. (1) Duplication of Plants to Be Avoided	
159. (2) Basis of Right for Protection Against Competition	
160. (3) Loss of Right for Protection Against Competition	
161. (4) Requisites for Authorization of New Enterprises	
162. Regulation of Rates	
163. Regulation of Operations	
164. Requirements of Public Policy—(1) Safeguarding Investments	
165. (2) Conserving Integrity of Credit	
166. (3) Promoting the Public Interest	
 XVI FIXED AND FLOATING CAPITAL AND THE ACCOUNTING THEREFOR	 335
§ 167. Fixed and Floating Capital	
168. Basis of Fixed Capital Accounts	
169. Necessary Detail for Fixed Capital Accounts	
170. Additions and Betterments Accounts	
171. Accounting for Fixed Capital Withdrawn	
172. Maintenance and Depreciation of Fixed Capital	

CHAPTER	PAGE
173. (1) Relative Importance of Maintenance Expense Accounts	
174. (2) Depreciation Accounts	
175. (3) Method of Recording Depreciation	
176. (4) Over- or Under-Statement of Maintenance to Be Avoided	
177. Accounting for Replacements of Capital	
XVII ISSUE OF STOCKS AND BONDS FOR ACQUISITION OF FIXED CAPITAL.	358
§ 178. Fixed Capital Classified	
179. Capitalization for Acquisition of Intangible Capital	
180. (1) Organization Expenses	
181. (2) Franchises	
182. (3) Patent Rights	
183. (4) Contract Rights	
184. (5) Other Intangible Capital	
185. Capitalization for Acquisition of Tangible Capital—(1) Construction	
186. (2) Construction Under Contract	
187. (3) Purchase of Plant	
188. Capitalization for Acquisition of Working Capital	
XVIII INTERCORPORATE RELATIONSHIPS, INVESTMENTS, CONSOLIDATIONS, MERGERS, AND REORGANIZATIONS . . .	394
§ 189. Intercorporate Relationships Defined	
190. The Development of Intercorporate Relationships	
191. Possible Dangers in Intercorporate Holdings	
192. Capitalization for Purposes of Intercorporate Holdings	
193. (1) Relationship Which Should Exist Between Projects of Affiliated Companies	
194. (2) Value of Stocks and Bonds Acquired to Support Those Issued	
195. (3) Company Acquiring Holdings Not to Burden Its Own Operations	
196. Holding Companies	
197. Stocks, Bonds, or Physical Properties Acquired as Investments	
198. Consolidations and Mergers	

CHAPTER	PAGE
199. (1) Capitalization of Consolidating Companies Important	
200. (2) When Values of Consolidating Properties Need to Be Considered	
201. (3) Considerations of Public Policy	
202. Corporate Reorganizations	
 XIX CAPITALIZATION FOR SUNDRY PURPOSES	 426
§ 203. Reimbursement of Moneys Expended from Income	
204. (1) Capitalization for This Purpose a Limited Right	
205. (2) Effect of Reimbursing Income by Stock Issue	
206. (3) Analysis of Accounts to Determine Amount to Be Reimbursed	
207. (4) Appraisals to Supplement or Check Accounting Analyses	
208. (5) Reimbursement of Proper Expenditures a Matter of Right	
209. Capitalization for Investment or Maintenance of Service	
210. Capitalization for the Discharge or Refunding of Obligations—(1) Funding Operations	
211. (2) Refunding Operations	
212. The Need for Constructive Regulation of Finance	

The Financing of Public Service Corporations

Part I—Corporations and Public Regulation

CHAPTER I CORPORATIONS

§ 1. Corporations Defined

A corporation is an association of persons who have united themselves or their capital for the performance of a definite purpose, and who, as such association, have secured from the sovereign authority of the jurisdiction in which the association is domiciled, a franchise to exercise certain powers beyond those comprehended within their natural rights as individuals. Chief of these powers is that of perpetual existence of the corporation, independent of the continued association of the persons who brought about its organization. Thus, the corporation becomes an independent entity, a thing, as it were, with a life of its own, vested with powers which it alone may exercise, and enjoying privileges not available to natural persons or partnerships.

Since it is in the exercise of these various privileges and rights that corporations most often appear in courts of law, there has arisen the legal definition, framed by Chief Justice Marshall in the Dartmouth College Case, that "a corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."¹

The legal definition relates more directly to the status of

¹ Dartmouth College v. Woodward, 4 Wheat. 518 (636).

the corporation in theory of law than to its organic nature; it personifies the corporation for the purpose of acting upon it and subjecting it to legal duties, or enabling it to exercise legal rights. The definition, therefore, considers the corporation as a complete entity and regards the individual members as mere component parts of the whole; for the purpose of legal action the emphasis is upon the corporate entity and the personal membership is made incidental. On the other hand, the definition given in the first paragraph is concerned with the organic nature of the corporation; it looks upon the corporation as a collection of individuals who have become vested with special powers and privileges according to the authority of the law; it lays emphasis upon the association of persons and makes the corporate form incidental to the accomplishment of the association's purposes.

The legal definition has been quoted too often without due reference to the human elements of the corporation, so that we have in common use such expressions as "fiction of law," "creature of statute," etc.—characterizations which are proper enough for legal purposes and, so far as they relate to the form of the corporation, properly reflect its existence not as a natural fact but in an assumed and artificial form created by the law; they fail utterly, however, to indicate that the corporate enterprise is a personal enterprise, that its acts are those of persons just like ourselves, that its profits accrue to the persons who have become associated in the enterprise and who depend upon those profits for **their** income, and that if no profit accrues theirs is the loss. That definition will be the most correct, and the most useful, which lays emphasis first upon the body, i.e., the association of natural persons, and second upon the cloak, i.e., the impersonal form through which those persons, under proper sanction of law, conduct their operations.

It is important to remember that the corporation comes into existence by sanction of law extended to the incorporators

who thereby become authorized to associate themselves under the corporate form. This right is perpetuated in the members of the corporation, no matter how their numbers or identity may change. Hence, the right to be a corporation is a franchise of the members of a corporation and not of the corporation itself.² Over this franchise the latter has no control; it may sell all other franchises and every bit of property or every claim that it possesses, but it cannot convey or assign the right to be a corporation. Neither can the members who own that right sell or transfer it except in the precise manner provided by the laws of the state from which the right was derived. They may surrender the right by dissolving the corporation; or it may be taken away from them because of their default in the performance of prescribed acts, or the commission of a fraudulent or prohibited act; they may also assign and transfer the right to another corporation through merger or consolidation effected in the manner prescribed by statute.

The association of a number of persons is essential to the organization of a corporation. An individual cannot incorporate; neither can one corporation become a direct party to the incorporation of another corporation.

§ 2. Joint-Stock Associations

The term "joint-stock association" is used with different meanings. The best understood meaning is that illustrated in the organization of the earliest companies which, because of the magnitude of the undertakings upon which they entered, had to operate under a form which would nullify the limitations of ordinary partnerships and also avoid the almost prohibitive difficulties involved in obtaining a charter from the Crown. Originally the only corporations known to English law were associations organized pursuant to charters granted by the sovereign. History has recorded the enterprises of the Mer-

² For a discussion of the differences between "general" franchises and "special" franchises, see § 181.

chant Adventurers of England, chartered by Richard II, in 1390; of the Russia Company, chartered by Queen Mary in 1554; of the East India Company, chartered by Queen Elizabeth in 1600; of the Hudson Bay Company, the Turkey Company, etc. The beginnings of the joint-stock principle are illustrated in the transactions of the East India Company, which during its earlier years used to form a "joint stock" for each voyage, made up of the contributions of groups of members who thereafter shared pro rata in the profits of that individual enterprise.

As these chartered companies increased in size and importance, Parliament began to claim regulatory authority over them and before long was granting charters of a similar nature. Along with this development came the organization of joint-stock associations under the common law. In substance these were simply large partnerships which used the device of transferable shares; the only differences in form were those necessitated by the size of the organization and the special machinery required to unify the control of the many members. Joint-stock companies were quite numerous at the end of the seventeenth century and the beginning of the eighteenth; they seem to have become almost as popular as some of the modern "trusts." The Bubble Act of 1719, taking its name from the speculative enterprise of the South Sea Company and enacted after the bursting of the "bubble" had caused a disastrous panic, declared these companies to be common nuisances and indictable as such. They continued to flourish, however, in spite of the Act, which was extended over the American colonies in 1741 and was eventually repealed in 1825. In the meantime incorporation by special parliamentary bills had come into general use.

§ 3. Joint-Stock Associations Defined

A joint-stock association has been defined as "an association of persons for the purpose of business, having a capital

stock divided into shares, and governed by articles of association which prescribe its objects, organization, and procedure, and the rights and liabilities of the members, except that the articles cannot release the members from their liability as partners to the creditors of the company.”³

This is the definition of a joint-stock association organized under the common law, and is to be distinguished from one organized and empowered by statute, as in England and New York State. The latter has a joint-stock associations law which includes the definition: “The term ‘joint-stock association’ includes every unincorporated joint-stock association, company or enterprise having written articles of association and capital stock divided into shares, but does not include a corporation; and the term ‘stockholder’ includes every member of such an association.”

“The distinction between joint-stock companies and corporations and the essential characteristics of each are not clearly defined,” is the opinion of one commentator,⁴ referring to this definition; while a decision of the Court of Appeals includes the statement that in New York “joint-stock companies have all the attributes of a corporation except the right to have and use a common seal.”⁵ The substantial difference between them is in the matter of liability. The members of joint-stock associations do not enjoy the privilege of limited liability which is common to stockholders of corporations.

Familiarity with the nature of joint-stock associations is very helpful in arriving at an adequate understanding of the nature, organization, and privileges of the modern corporations of which they were the forerunners. Some of the large express companies now operating are joint-stock associations. In reports of the Public Service Commission, Second District, New York, the Adams Express Company is described as a “joint-stock association formed by voluntary agreement under

³ Cook on Corporations, Seventh Edition, Vol. 2, page 1465.

⁴ White on Corporations, page 1086.

⁵ People *ex rel.* Platt v. Wemple, 117 N. Y. 136; see also Hibbs v. Brown, 190 N. Y. 167.

the common law of the State of New York"; the American Express Company "is not a corporation, but a voluntary partnership or association of persons organized under articles of agreement between its members under the common law of the State of New York"; and the National Express Company is "an unincorporated association organized under the common law of the State of New York . . . with a nominal capital of \$500,000." In the tabulated balance sheets the entries against the item of capital stock are explained by a note that the "Respondent is an unincorporated joint-stock association, but for convenience reports on the liabilities side of the balance sheet at a nominal par value the shares representing the beneficial interest of its members."

§ 4. Classification of Corporations

Corporations are broadly divided into two classes—public and private.

Public corporations are governmental institutions, e.g., cities and incorporated villages, which are political subdivisions for the administration of the public affairs of the community.

Private corporations may be classified into a number of groups, each differing from the other in form, in kind or degree of powers to be exercised, or else in general purpose. A classification as to general purpose may be as follows:

1. Ecclesiastical corporations
2. Eleemosynary corporations
3. Civil corporations

A simpler and more convenient classification is that contained in the General Corporation Law of New York which may be said to group corporations according to form. "A corporation shall be either

1. A municipal corporation
2. A stock corporation, or
3. A non-stock corporation"

Municipal corporations come within the general class of public corporations, leaving private corporations classified into stock and non-stock corporations. Non-stock corporations are also called membership corporations; they are those not organized for private gain, and include both the first and second groups of the classification first made, i.e., ecclesiastical and eleemosynary corporations. These represent associations of persons who have united themselves primarily, and their capital only incidentally or not at all, for the performance of a definite purpose. Hundreds of political organizations, for instance, are incorporated every year to support the candidacy of one nominee or of another, and their membership contains large numbers of persons who have simply pledged themselves to the cause.

Stock corporations come within the classification of civil ⁶ corporations and are those organized for private gain; they represent associations of persons who have united their capital primarily, and themselves only incidentally, for the performance of a certain purpose. It is true that in many instances the members have not only contributed their capital but are also devoting all of their knowledge, time, and skill to the business of the corporation, but in these instances the members who perform such service have been elected as officers or engaged as employees of the corporation.

Corporation finance deals only with the affairs of stock corporations. It will be well worth while, therefore, to give a comprehensive definition of stock corporations by way of introduction.

§ 5. Stock Corporations

A stock corporation is an organization of persons who have united their capital in an enterprise for the purpose of deriving a profit therefrom, and who, by contracting each with the other and all collectively with the state, have had their

⁶ "To facilitate the conduct of business," Standard Dictionary.

organization endowed with corporate existence for a specified period of years or in perpetuity, and with other specific or incidental powers to be exercised in the corporate conduct of the enterprise. The contribution of each member to the capital of the corporation measures the proportion, subject to qualification by agreement between the members, of his share in the control, capital, and profits of the corporation; it also measures the extent of his financial responsibility in the corporate enterprise and limits his liability for the corporate debts.

If a statutory definition is preferred, reference may again be made to the New York law which defines a stock corporation as "a corporation having a capital stock divided into shares, and which is authorized by law to distribute to the holders thereof dividends or shares of the surplus profits of the corporation. A corporation is not a stock corporation because of having issued certificates called certificates of stock, but which are in fact merely certificates of membership, and which is not authorized by law to distribute to its members any dividends or share of profits arising from the operations of the corporation."

The privilege of limited liability is undoubtedly the most noteworthy attribute of a stock corporation. The individual owners of a business and those associated in general partnership take upon themselves personally full liability for all debts incurred in the business; but those who are associated as proprietors of an incorporated business are not charged with personal responsibility for any of the corporate debts beyond the amount of their agreed contributions to the stock of the corporation, except that under certain circumstances they become liable for amounts due to employees as wages.

§ 6. Corporate Charters

A corporation becomes incorporated when it receives from the sovereign authority legal sanction to exercise corporate rights. The grant of that sanction necessarily involves the

acceptance of the purposes of the association, which must accord with public policy; hence, an association whose objects are opposed to public policy and interest, or which are immoral or illegal, cannot be incorporated. The mere fact that incorporation has been effected in form will not estop the grantor from later questioning the propriety of the objects and nullifying the corporate privileges if necessary.

1. *Federal Incorporation.* In the United States, sovereign authority is vested in the individual states, and these states have delegated certain sovereign powers to the Congress of the United States. Congress, therefore, does not possess authority to incorporate or charter private corporations (outside of the District of Columbia) except as it has received delegated authority from the states. Under its constitutional power of controlling currency, Congress has chartered national banks; it can exercise like power as to interstate carriers and other corporations engaged in commerce, under its constitutional power to regulate interstate commerce or to establish post-roads and post-offices. It has twice chartered railroad corporations under the authority of its control over post-roads; the first one was the Union Pacific Railroad, chartered July 1, 1862, and the other the Northern Pacific Railroad, chartered July 2, 1864. Congress has, however, frequently been urged to enact general incorporation laws, either requiring interstate carriers to incorporate thereunder so as to derive all their powers from the federal government and be responsible to it, or giving them the option of a federal or state charter. Some such legislation will undoubtedly be enacted before long in the logical extension of the jurisdiction now exercised by the federal government over rates, operations, accounts, etc., of interstate carriers under the constitutional authority to regulate interstate commerce.

2. *State Incorporation by Special Act or General Law.* Incorporation was at first effected by the direct and specific action of the sovereign authority; for instance, the charter

from the Crown or Parliament, and after the independence of the American Colonies, from the legislatures of the individual states. For more than half a century in this country incorporation by special act of the state legislatures was the only method in use; the corporation was created by the enactment of a special statute which named the incorporators and organized them into "a body corporate and politic"; it then enumerated the powers, defined the privileges and duties, and became the charter of the corporation—the authority for its existence and activities.

The method was satisfactory as long as the number of associations seeking incorporation was limited; but the number of these increased yearly until at last the enactment of the many statutes required became too great a burden for the legislatures. In order to dispose of them all, the work of introducing and passing special acts was at times necessarily perfunctory and indiscriminate. It was but natural that under such conditions abuses of the privilege should creep in, suggesting to many people the existence of legislative corruption; moreover, the corporate form had become so important a device in the development of commercial and industrial enterprises that its free and unrestricted use was generally advocated. All of these considerations required the introduction of a more expeditious and general method of incorporation; so, instead of enacting a separate and special statute for each corporation, legislatures enacted general statutes which prescribed the conditions under which, and the purposes for which, incorporation might be had; also providing the machinery to register compliance with the conditions and the extension of the authority of the state for the creation of the corporation. The enactment of such general incorporation laws was universal in this country, and all states now provide for the organization of corporations under general laws.

The New York Constitution contains a provision, inserted in 1846, reading as follows:

"Corporations may be formed under general laws; but shall not be created by special act, except for municipal purposes, and in cases where in the judgment of the legislature the object of the corporation cannot be attained under general laws. All general and special acts passed pursuant to this section may be altered from time to time or repealed."

Incorporation under general laws is now effected by filing with the proper state officials a certificate prepared by the incorporators in statutory form and manner. In New York the certificate must be filed with the Secretary of State and with the clerk of the county wherein the office of the corporation is to be located. These are the usual requirements of most states. The filing is the act of incorporation and the date thereof is the date of incorporation. The charter of a corporation so organized consists of the statute and the certificate of incorporation. The latter, by setting forth the facts concerning organization and incorporation, and describing the powers to be exercised, links up the statute with that one corporation; thus, in place of general provisions applicable to many corporations, it substitutes by appropriation a set of specific provisions applicable to and controlling the single corporation thereby created.

§ 7. Corporate Powers

Those things which the corporation is legally authorized to do are its powers, and these may be express or implied. Express powers are those specifically described and enumerated in the charter, whether that be a special legislative act or a general act operating upon the corporation through the latter's certificate of incorporation. Implied powers are those which the corporation must exercise as a natural incident of conducting the business or doing the things which it has been expressly authorized to do. The implied powers are enumerated as follows:

"To buy, hold, and sell necessary real estate and other

property in its corporate name; to sue and be sued in that name; to do business in its corporate name without rendering its stockholders liable as partners for its debts; to govern its officers, agents, and business by by-laws; to issue transferable certificates of stock to its stockholders; to have its business managed by directors instead of by the stockholders as in a partnership; to continue business although its stockholders die or sell their stock; to borrow money and give bills, notes, and acceptances; to issue negotiable bonds; to assign for the benefit of creditors; and, except in *quasi*-public corporations, such as railroads, to give a mortgage.”⁷

§ 8. The Instruments of Corporate Finance

Two things are essential to the inception and maintenance of every business enterprise—capital and skill. When business enterprises were conducted in small units, both of these essentials were furnished by the one person who owned and conducted the business; his was all the risk, and his all the profits, representing both compensation for labor and return upon capital. Just a step farther, two or more persons united in partnership, furnished the capital, and divided the conduct of the business between themselves, sharing in the risk and profits. As business increased to larger proportions, even the ordinary partnership proved inadequate, for business demanded the capital of those whose active participation in the management of the enterprise was not desired and was impracticable because of their number. Thus there was developed the joint-stock and later the incorporated association, their growth keeping pace with the development of wealth and credit facilities. First they attracted the capital of those who would share the risk and the profits—these were investors in proprietorship; then they had to attract the capital of those who were not willing to invest in proprietorship but who would lend their money for use in the enterprise but not sub-

⁷ Cook on Corporations, Seventh Edition, Vol. I, page 11.

ject to the risk thereof—investors in credits. Hence the present task of corporate finance, which is that of bringing together the resources of the capitalist and the skill of the operator, and of so dissociating the incidents of ownership and allocating the net income as to pay interest to the investor in credits, compensate the operator, and divide the profits among the investors in proprietorship.

The instruments of corporate finance consist of shares of stock, representing interests of proprietors, and bonds or other certificates of indebtedness, representing claims of creditors. This is a very general classification, and each group includes many subclasses which will be noted hereinafter.

CHAPTER II

PUBLIC SERVICE CORPORATIONS AND COMMISSIONS

§ 9. Public Service Corporations

"Private" corporations have been already distinguished from "public" corporations in a general classification. In recent years the term "private" corporation, as ordinarily used, has come to have a somewhat different meaning through the introduction of another term, "public service" or "public utility" corporation, the latter referring to a corporation whose business enterprise is subject to such a degree of public interest as to give it distinctive status.

It is necessary to emphasize that the distinction is largely a question of the relative *degrees* of public interest. Many attempts have been made to find the basis of distinction in the enterprise itself, but without success. Much of the difficulty may perhaps be obviated if it is understood that the characterization of "public service corporation" indicates not so much the inherent nature of the undertaking as it does the nature of the relationship between the corporation and the public. A corporation considered today to be engaged in a purely private undertaking may tomorrow be considered as engaging in a public service undertaking; the undertaking itself remains the same, but some change in the condition of the community modifies the relationship theretofore existing. The relationship itself, however, is governed by well-defined principles.

Ever since commerce became a well-defined part of the social structure, certain enterprises have been considered to partake of the nature of a public calling, and those who en-

gage in them are held to be under special and extraordinary obligations to the public; for instance, they are under the duty of serving all comers alike, while the owner of a private enterprise can serve or refuse to serve whomsoever he pleases. The development of the law of public service corporations constitutes one of the most interesting chapters in the history of our economic progress. The transition from the small individual enterprises of the period when the law of carriers and similar companies first began to be formulated, to the large corporate enterprises of today, has been very great indeed; equally great has been the development of the law from the first definition of special duties to the present voluminous body of law, both common and statutory, relating to public service corporations.

§ 10. What Constitutes Public Service

What are the distinguishing or significant characteristics of the public service corporation? Upon what circumstances does the existence of its peculiar relationship to the community depend? What tests can be applied to determine whether it is engaged in a private or a public service undertaking?

Common Carriers. "A common or public carrier is one who undertakes as a business, for hire or reward, to carry from one place to another the goods of all persons who may apply for such carriage, provided the goods be of the kind which he professes to carry, and the person so applying will agree to have them carried upon the lawful terms prescribed by the carrier; and who, if he refuses to carry such goods for those who are willing to comply with his terms, becomes liable to an action by the aggrieved party for such refusal.

"To bring a person, therefore, within the description of a common carrier the following characteristics must appear:

1. He must be engaged in the business of carrying goods for others as a public employment, and must hold himself out as ready to engage in the transportation of goods for persons generally as a business, and not as a casual occupation.

2. He must undertake to carry goods of the kind to which his business is confined.

3. He must undertake to carry by the methods by which his business is conducted and over his established road.

4. The transportation must be for hire.

5. An action must lie against him, if he refuses without sufficient reason to carry such goods for those who are willing to comply with his terms. And this duty or obligation to the public by reason of the public nature of the employment and the increased responsibility imposed upon him by the law upon the grounds of public policy, mainly distinguish the common from the mere private carrier for hire."¹

The above is one of the best definitions available; at the same time it is an excellent example of the inadequacy of the definitions on this subject. Notice that among the inherent qualities which distinguish the common carrier from other corporations is included the fact that "an action must lie against him" for refusal to serve as a common carrier. Manifestly, that such an action will lie must depend upon a prior determination that the party proceeded against is a common carrier. The definition of the nature of the undertaking is mixed with the description of the status ascribed to the corporation engaged in that undertaking; whereas, there is no difficulty in establishing the status of the corporation after it is once established that it is engaged in a public service undertaking. Confusions such as this are to be found in most of the general definitions usually relied upon and it is difficult, therefore, to formulate a comprehensive rule.

Other Public Service Corporations. Common carriage as a test of a public calling is applicable, obviously, to carriers alone. It is a test and nothing more; for other classes of persons or corporations engaged in a public calling or service there will be found other and equally satisfactory tests. These

¹ Hutchinson on Carriers, Third Ed., Vol. I, sections 47-48, pages 41-42. Quotations rearranged in paragraphs for convenience here.

tests are valuable, but a clear-cut definition of what shall be deemed to constitute a public undertaking, uniformly applicable to all kinds and classes of public service, would be of immeasurably greater worth. Public service corporations, so called either because of the principles of the common law or because of statutory designation, in addition to including all the common carriers,² from the earliest types to the latest—from stage coaches to jitneys, with all the other modes of common transportation in between, e.g., horse-cars, steam railways, cable roads, electric roads, steamships, etc.—together with those who furnish collateral carrier service, e.g., express companies, sleeping car companies, etc., also include many other kinds of businesses, such as the operation of telephone and telegraph systems; the generation, transmission, and distribution of electricity, gas, and steam; the storage and distribution of water for general or irrigation purposes. Sewer companies, toll bridge companies, warehousemen and elevatormen, wharfingers, etc., are in the list.

The Massachusetts Public Service Commission has ruled that companies furnishing stock ticker service are public utilities, while the New Jersey Commission exercises jurisdiction over ice companies and the Oklahoma Public Service Commission over cotton-gins. What inherent quality or qualities do these undertakings possess in common with each other so that they can all be grouped under the one general head of public service undertakings? These have been said to be enterprises in which the community itself—municipality, state, or nation—could properly engage without running counter to the theory of governmental functions. But what domain of industry or commerce have not governments gone into? They have not been limited to the operation of railroads, or water distribution systems, of telephone and telegraph lines, of lighting plants, and similar services. The activities of municipalities

² There is a tendency to distinguish between public service corporations and common carriers. The term "public service corporation" is used throughout this book to include common carriers as well, unless a distinction is clearly indicated.

have at times included the manufacture and sale of commodities. No one has yet prescribed a rule which will distinguish between those operations which are within the legitimate activities of governmental agencies and those which must be left to private enterprise.

The Constitution of the State of California provides: "Every private corporation, and every individual or association of individuals owning, operating, managing, or controlling any commercial railroad . . . is hereby *declared to be a public utility* subject to such control and regulation by the Railroad Commission as may be provided by the legislature, and every class of private corporations, individuals, or associations of individuals *hereinafter declared by the legislature to be public utilities* shall likewise be subject to such control and regulation."³

Relation to Needs of Community. It is well to note that under the above law the legislature may declare certain corporations to be engaged in public service undertakings which theretofore had been thought to be conducting purely private enterprises. The new status of any one corporation will rest upon legislative declaration, i.e., the statement of a finding as to existing facts. The business has not changed, it remains just the same as before; the status of the corporation is changed, for it becomes "subject to such control and regulation by the Railroad Commission as may be provided by the legislature." Obviously, the business itself is not the subject matter of the declaration but rather the relation of that business to the needs, condition, and circumstances of the community wherein it is conducted.

If this statement is true, then it becomes easy to understand why cotton-gins, for example, may be called public utilities in communities where they represent an essential part of the industrial and social life of the people. The conditions surrounding many other enterprises heretofore considered

³ Article 12, Section 23. Italics used here are not found in original.

purely private in nature may in time change so as to bring them within the category of public service undertakings.

In a leading case involving the question of a public undertaking, the United States Supreme Court repeated the rule of the common law as follows:

"We find that when private property is 'affected with a public interest, it ceases to be *juris privati* only.' This was said by Lord Chief Justice Hale more than two hundred years ago in his treatise, *De Portubis Maris*, 1 Harg. Law Tracts, 78, and has been accepted without objection as an essential element in the law of property ever since. Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control."⁴

§ 11. Rule as to Determination of Public Service Corporations

Summed up, the general rule may be stated as follows: Any manufacturing, trading, transporting, or other business undertaking which produces a commodity or renders a service essential to the economic and social welfare of the community in which it operates, so that the constant availability of its commodities or service in satisfactory mode, quality, and relation to public demand must be assured, and where the production or rendition of the commodity or service is or ought to be under unified and exclusive control within that community, will be deemed to be a public service undertaking. Consequently, the corporation engaged therein may, at such

⁴ *Munn v. People*, 94 U. S. 113 (1875).

times as public policy will warrant and demand, be declared to be a public service corporation, subject to the special duties and responsibilities contemplated by that relationship.

The necessity for unified and exclusive control of production indicates that the undertaking is a natural monopoly. Artificial monopoly which may be corrected should not be brought within this description. Some measure of necessarily monopolized supply is essential to charge the undertaking with a compelling public interest. If the would-be purchaser may choose between a number of vendors and is under no compulsion to go to any special one, it is difficult to charge the business of those vendors with a compelling public interest, for here competition is an effectively regulating force. There may, of course, be differences in the extent of the public interest with which different undertakings may be chargeable; the greater the interest, the more surely will the undertaking become an integral part of the life of the community. People fix their residences and establish their factories, offices, and stores according to available transportation facilities, water supply, gas, electricity, etc.; they direct their business and social relationships by means of the telegraph and telephone, so that all of these agencies become as the arteries of a living organism. Hence, having been once established and projected into the life of the community, these agencies must be maintained; they cannot be withdrawn at the will of the owners and operators without the concurrence of the public. The necessity for the continuance of the service, if it is of a public nature, becomes compelling and imposes upon both the owners of the undertaking and the public that is served mutual and reciprocal duties.

§ 12. Relationship Between Public Service Corporations and the Public

It is not necessary to go into any lengthy discussion of the legal status of public service corporations and of the special

duties to which they are subjected. Having determined what a public undertaking is, however, it is worth while to inquire briefly concerning the relationship between the public and the corporation engaged in that undertaking, for there has been much misstatement on the subject. Some describe the corporation as a trustee in charge of a public trust; others regard it as an agent for the community. In both cases the fundamental assumption is that since the undertaking is one in which the public, through its organized governmental units, could itself engage, the present control of that undertaking by a private corporation is merely by sufferance and subject to a constructive agreement to operate as agent or trustee. The logic is faulty, for the fact that the government could or could not engage in a similar enterprise has nothing to do with it. The proponents, however, find some support in the terminology of decisions and treatises. The following definitions are quoted over and over again:

"A railroad is a public highway, and none the less so because constructed and maintained through the agency of a corporation deriving its existence and powers from the state. Such a corporation was created for public purposes. *It performs a function of the state.*"⁵

"It is not the water or the distributing works which the company may be said to own, and the value of which is to be ascertained. They were acquired and contributed for the use of the public; *the public may be said to be the real owner, and the company only the agent of the public to administer their use.*"⁶

Some theorists extend the relationship to that of partners, and in support of their contention emphasize the grant of franchises and public rights. The fundamental defect in this as well as the other theories is that the relationship of either agent or partner involves duties and responsibilities on the part

⁵ Smyth v. Ames, 169 U. S. 466 (544). Italics are not to be found in original.

⁶ San Diego Water Co. v. San Diego, 118 Calif. 556 (570). Italics are not to be found in original.

of the public which the latter has not always been willing to assume, such as securing the investment in these enterprises and guaranteeing a return thereupon by protecting the corporation from undue competition, using its influence to procure adequate rates for the service rendered, etc. The tendency of regulation by commission has been to recognize these compensating duties, but the introduction into legislatures of special bills overruling the decisions of commissions, the enactment of arbitrary rate schedules into law, the readiness to legislate as to expenses, and the absolute refusal to pass any laws affording direct relief, evidence the apparent unwillingness of the public to accept the obligations in full. It is fair to say, however, that the real attitude of the public has not yet been correctly expressed. Hitherto there has been too great confusion because of direct charges of stock-watering and corporate wrongdoing, and countercharges of unfairness, of strike-bills, and of legislative or municipal hold-ups, so that both sides have resorted to means the employment of which was, to say the least, inexpedient. The matter is one that should be considered without animus or prejudice.

It does not seem necessary to introduce either the rules of agency or partnership. The definition of a public service as given above indicates clearly that when a public interest attaches so as to impose special duties upon the public service corporation, compensating duties are contemporaneously imposed upon the public as well, and both parties may thereafter proceed on the assumption that these direct or compensating obligations will be fully carried out. The nature of the duties to which the corporation is subject is clearly understood; the compensating duties of the public have not been so often brought into question and they have escaped the emphasis of frequent reiteration. The grant of franchises and the extension of other necessary aids in the establishment and maintenance of the undertaking are the main incidents of the public responsibility.

§ 13. Regulation by Commission

Regulation by commission may be said to be a general term describing the effort, now a mutual one between the corporations and the public, to formulate a satisfactory and working basis for the thorough understanding of each other's rights and the reciprocal performance of their duties and obligations. The principles of regulation are of long standing, and, although its methods appear to be new, the innovations are no more than those which were required by reason of the vast number of public utilities, their increasing variety, and the expansion of individual undertakings.

Any review of the development of corporation regulation as it now exists must necessarily deal largely with the regulation of railroad corporations and other common carriers, since during many years these comprised the principal group of public service corporations subjected to regulation. The legislation for those classes of corporations has shaped the later legislation for all classes of public service corporations. The more recent movement for the regulation of other classes of corporations is bound to follow very closely the principles and methods established in the field of public utilities.

There was a distinct advantage in incorporating public service corporations by special act of the legislature. The introduction of these bills gave valuable opportunity for discussion of the merits of the proposed enterprise and afforded interested parties the privilege of a hearing. Thus the necessity or desirability of each proposed railroad, for instance, was passed upon by the legislature itself, and the legislation could be shaped so as to protect the public interest. Early railroad charters contained many unusual provisions as to operation, while the inclusion of schedules of rates was quite common.

The change from the system of incorporation by special act to that of incorporation under general laws has already been described. The development of railroad regulation in

New York from that time on is both interesting and instructive.

Abuses Under the 1850 Law. Incorporation under general laws did not at first carry with it the right of condemnation, which was a power still jealously guarded by the legislature and which could be exercised only upon specific authorization of the legislature. Some measure of control over the launching of new railroad enterprises thus remained with the legislature, but even that was relinquished in 1850 by the enactment of a general railroad law under which railroad corporations were given outright and without restriction the power of condemning the property necessary for their purposes. The complete abandonment of every vestige of regulatory control over the entrance of new corporations into a field already occupied, or over their construction and operation, proved very unsatisfactory. A small number of persons could, simply by filing a certificate, organize a railway corporation with full power to take property by condemnation and to build a road wherever and in whatever manner they saw fit, and to operate it as they pleased.

It was no wonder that such privileges were abused; improper practices crept into the organization and management of railroads under this system of unrestrained incorporation and free competition—abuses which were financially and economically disastrous in many instances, which brought rate wars, and forced resort to unscrupulous business methods in the struggle for existence; it was apparent that very often the power to condemn property was being used by so-called railroad corporations, lacking both capital and ability to engage in operation, to block legitimate construction and to compel the purchase, at exorbitant prices, of the rights which they had acquired under such false pretenses.

The results of ensuing rate wars and of competition which exhausted the resources of both competitors soon began to produce a change in the politico-economic attitude toward

these corporations whose naturally monopolistic nature was gradually recognized. The necessity of state governments reacquiring the regulatory control which they had so lightly surrendered then became imperative, and first steps toward that end were taken by the creation of regulatory boards.

The First New York Commission Law. In New York State an organized movement for the creation of a Board of Railroad Commissioners was commenced in 1879, and resulted in the creation of such a commission in 1882, the Board of Railroad Commissioners taking office January 1, 1883. Some other states had already taken this step and others soon followed, for it was a popular movement. Very little power and authority were given to these boards in the beginning, but through succeeding years their powers and functions were expanded, especially in regard to the construction of new roads, changes in rates, and fluctuations in the quality of service. Enforced publicity of financial practices and results of operations were among the latest extensions of their functions.

§ 14. Public Service Commissions

The state supervision and regulation thus instituted first over railroads has been extended during the last quarter of a century, reaching a high efficiency in the public service, or public utility, commission laws in many states, notably those of New York, Massachusetts, Wisconsin, and California. The jurisdiction of these commissions covers practically all classes of public service corporations; there are some comparatively unimportant differences in the classification contained in the laws of the various states, but these are of local interest and need not be enumerated here.

In some states these commissions act under constitutional authority, while in others they have been created solely by legislative enactment. In either case, they represent the agency by which the state exercises direct regulatory authority

over the corporations which it creates, and they also administer certain measures of regulatory authority over corporations not created by that state, but whose operations and activities therein bring them within state jurisdiction in some respects. It is necessary to keep in mind that control exercised over a corporation itself under the general authority of the state and independently of jurisdiction over the corporation's business, is a different situation from that of control exercised over the business and activities of the corporation primarily and over the corporation itself only incidentally or collaterally. The first rests upon the general sovereign authority of the state; the latter upon the more limited authority of police power.

The powers of the Public Service Commissions⁷ of New York may be said to be typical of the extent of supervision and regulation exercised by all commissions working under a policy of comprehensive regulation. Briefly summarized, the powers and duties prescribed by the New York statute as relating to the corporations placed within the jurisdiction of each commission are as follows:

New Enterprises. Before a corporation may build a new railroad or extend one into new territory, it must receive from the Commission a certificate of public convenience and necessity as to the proposed construction; similarly, corporations organized to conduct other public utility enterprises may not enter upon the construction of their plants or exercise any right or privilege under a franchise without first obtaining the proper consent of the Commission.

No corporation may sell or transfer any part of its plant or franchises to another corporation without the consent of the Commission.

Intercorporate Relationships. No corporation may lease its franchises or property, or make any contract or agreement

⁷ The plural is here used because there are two Commissions in New York, one for the First District, taking in the territory of New York City, and the other for the Second District, taking in the remainder of the State.

in relation to the ownership or operation thereof without the authorization of the Commission.

The acquisition by one public service corporation of the stock of any other similar corporation must have the authority of the Commission.

Operation. The Commission may, upon its own motion or upon a complaint before it, investigate operating conditions and appliances, order proper regulations and rules to be adopted, or require necessary changes and repairs of plant or equipment to be made. It may fix standards for measurement of purity or illuminating power of gas, and "prescribe from time to time the efficiency of the electric supply system of the current supplied, and of the lamps furnished."

Rates and Charges. Upon its own motion or upon a complaint, the Commission may ⁸ make investigation and determine what shall constitute just and reasonable rates and charges.

Capitalization. No stocks, bonds, or certificates of indebtedness maturing in more than one year, may be issued by any corporation without the authorization of the Commission, which must also prescribe the conditions of issue and sale, and direct the disposition of the proceeds.

Accounts. The Commission may establish uniform systems of accounts and forms of records and memoranda. It has full power to examine the books and accounts, either in cases where they are brought directly into question, or for the purposes of its own information. It may even direct specifically the accounting entries to be made in recording an individual transaction.

Reports. Annual reports are to be furnished to the Commission, which may also call for any other regular or special reports, or for specific information upon particular points. Reports rendered to the Commission are made public records, and abstracts thereof are required to be published.

⁸ If the complaint is properly made, the Commission must, of course, make the required investigation.

Reorganizations. Reorganizations are subject to the supervision and control of the Commission.

The powers delegated to public service commissions, and the general purpose which they are intended to accomplish, have been summarized very well by the Public Utilities Commission for the District of Columbia:

"The spirit and letter of the Public Utilities Law charge the Commission with ascertaining and keeping itself informed as to the manner and method in which the business of every public utility is conducted. It is charged with supervision and regulation of the utility's organization, franchises, property, finances, accounting, rates, operation, and its compliance with every law applicable to it, including the provisions of its own charter. It is armed with ample inquisitorial powers to obtain information in any detail."⁹

§ 15. Federal Interstate Commerce and Trade Commissions

Power to regulate commerce between the states is delegated by the states to the Congress of the United States, and under this authority the federal government has embarked upon a very comprehensive program of regulating interstate commerce corporations. Here, of course, jurisdiction is acquired first over the business in which a corporation is engaged, and it is then extended to control over the corporation itself. While the delegation of authority over *interstate commerce* is broad enough to make federal jurisdiction exclusive if and when exercised, the extension of that authority over the *corporation* engaged in that interstate commerce does not become similarly exclusive against the state which created it.

The constitutional authority (Article I, Section 8) is as follows:

"The Congress shall have power: 3. To regulate com-

⁹ *In re Washington Railway and Electric Co.*, P. U. R. 1915—F. 34 (41).

merce with foreign nations, and among the several states, and with the Indian tribes."

There is a related section which may some time be taken advantage of to provide a method of vesting in the federal government exclusive jurisdiction over certain classes of corporations. The method must necessarily be that of federal incorporation. This "post-roads" section of the Constitution is as follows:

"The Congress shall have power: 7. To establish post-offices and post-roads."

Exercising its powers under the commerce clause, Congress in 1887 created the Interstate Commerce Commission, and since then has been constantly granting it more and more authority. This has been supported by judicial decisions which have reflected the growing sentiment for unification of control. The powers of this Commission are very similar to those enumerated above for the Public Service Commissions of New York, keeping in mind the limitation to interstate commerce, and omitting jurisdiction over corporate organization, reorganization, or capitalization. Definitions of intercorporate relationships are not embodied in the Interstate Commerce Commission Act itself, but specifically provided for in the Clayton Act which was an attempt at correlating anti-trust laws and judicial interpretations.

Extending its jurisdiction to include corporations not brought within the Interstate Commerce Commission Act, a Federal Trade Commission was created by Congress on September 26, 1914, and certain additional powers were also conferred upon it by the Clayton Act, approved October 15, 1914. The Trade Commission organized March 16, 1915, merging into itself the Bureau of Corporations. The Commission's report for the year ended June 30, 1916, summarized its powers as follows (page 14):

All of the powers which the Commission is empowered by the Trade Commission act to investigate or determine, in-

volve questions of fact and require work which is partly, and often wholly, of an economic character, namely:

1. To investigate the organization, business, conduct, etc., of corporations.¹⁰ (Sec. 6, par. a.)
2. To require annual and special reports from corporations. (Sec. 6, par. b.)
3. To investigate and make recommendations concerning the observance of decrees in anti-trust cases. (Sec. 6, par. c.)
4. To investigate alleged violations of anti-trust laws. (Sec. 6, par. d.)
5. To recommend adjustments of corporations alleged to be violating anti-trust acts. (Sec. 6, par. e.)
6. To investigate trade conditions in and with foreign countries, particularly with respect to combinations. (Sec. 6, par. h.)
7. To recommend appropriate form of decree in anti-trust cases. (Sec. 7.)
8. To determine and prevent unfair methods of competition. (Sec. 5.)

The same is true of those provisions of the Clayton Act, the enforcement of which is entrusted to the Commission. These provisions relate to

9. Price discriminations. (Sec. 2.)
10. Tying contracts. (Sec. 3.)
11. Intercompany stockholding. (Sec. 7.)
12. Interlocking directorates. (Sec. 8.)

Broadly speaking, the economic work under these powers may be grouped as follows:

1. Compilation of information of a general character through corporation reports.
2. Specific investigations of particular corporations, industries, or business problems, including those relating to the enforcement of the anti-trust laws.
3. Investigation of cases arising under the quasi-judicial, or administrative powers of the Commission under section 5 of the Trade Commission Act, and Sections 2, 3, 7, and 8 of the Clayton Act.

¹⁰ Except banks and companies within jurisdiction of Interstate Commerce Commission.

Part II—Capital Stocks

CHAPTER III

ISSUE AND TRANSFER OF CAPITAL STOCK

§ 16. Capital and Capital Stock

The primary purpose in organizing a stock corporation is to accumulate in one sum and apply to one enterprise the capital of many persons. All the special features of corporate organizations, e.g., limited liability of members, control of operations through boards of directors, etc., are designed to facilitate the accomplishment of this purpose. Each person who comes within the organization also contributes of his own capital. The aggregate of these contributions becomes the capital, capital fund, or capital stock on hand, of the corporation, to wit, the total amount of wealth which becomes accumulated in its hands to be devoted to the production of additional wealth through its enterprise and for the benefit of the contributors. In reality, its capital is that of the members, and its enterprise is their enterprise: if it is successful, they gain the profits; if it fails, they lose their investment. Hence, in the proportion that his contribution bears to the whole, each contributor acquires a proprietary interest in the capital of the corporation and the increment of that capital. Because of expediency, and to insure the continuance of the enterprise by maintaining intact its capital, the interest of each member is an undivided interest. The individual member cannot exercise direct dominion over any part of the corporate assets, or claim the personal use and possession of any proportionate share, until there is made a lawful distribution among all the

members, of either the whole (as upon dissolution) or a part (as the dividing of profits) of the corporate assets.

It is very apparent that where there are a number of contributors, the determination of each one's proprietary interest and the definition of the extent to which each may participate in the control of the enterprise or share in the distribution of the capital or the profits, may become a very complicated matter. For uniformity and ease in this respect, the measure of each individual contribution is resolved to a common denomination. When the total amount of the capital to be invested in the corporate undertaking has been determined, and its collection from contributors has been authorized, that becomes the *authorized capital stock*. This authorized capital stock is then divided into *shares* of equal amounts; these are *shares of capital stock*, and the amount assigned to each share is its *par value*. These are incidents of incorporation; after incorporation each intending member contributes to the capital of the corporation the amount of one or more shares; he then becomes a stockholder with an interest in the corporate enterprise, in like proportion as the number of shares he acquires bears to the total number of shares acquired by all the stockholders, provided, of course, that there is no agreement modifying the relationship. To each stockholder the corporation executes a *certificate of capital stock*, in ultimate effect tantamount to a receipt, reciting the number of shares which he has acquired, describing his interest in the corporation, and defining the special terms and conditions, if any, in accordance with which that interest will be given effect.

At the outset of the corporate enterprise, *capital* and *capital stock* represent the same substance considered in different aspects. *Capital* is the sum of the wealth possessed and to be used; as such it is an asset and will be the first item on the assets side of the corporate balance sheet. *Capital stock* is the sum collected from stockholders; it is not and cannot be a

debt of the corporation, but since it represents the principal sum of the investment of the stockholders to be returned to them should the corporate enterprise be then or thereafter abandoned, it is a responsibility, or an accountability, and it will be the first item on the liabilities side of the balance sheet. The equation is: Capital=Capital Stock. In the second part of the equation capital stock is used in the sense of the aggregate amount received from the issue of the shares, i.e., number of shares times the amount per share. Assuming that shares are issued at par, the second part of the equation can be changed to read "Par Value of Capital Stock." Almost immediately, however, this correspondence between capital and capital stock will begin to be destroyed; the capital sum will be increased or diminished; new assets will be brought in and liabilities incurred, so that capital will constantly fluctuate, changing its form and its value; capital stock, on the other hand, will continue to record the historical fact of the total capital contributed, the loss therefrom or the increase thereto being reflected in other accounts. The *value* of the capital stock will always be, however, as it was in the very beginning, the value of the net capital or assets after allowance has been made for all liabilities.

It must be admitted that "capital stock" is not a particularly appropriate term, especially for accounting purposes; when analyzed, its meaning cannot be distinguished from that of "capital," and as such it implies an asset on hand. If it were strictly interpreted, it would find no place on the liabilities side of the balance sheet. An individual conducting a business of his own records his interest therein under the usual caption of "proprietorship"; that, however, shows his actual interest at the time and differs in that respect from the corporate entry of capital stock, for the latter continues to record the capital originally contributed, as already noted, and the actual existing interest of the stockholders can be ascertained only by referring also to the balance of "Cor-

porate Surplus or Deficit" account. A better term than "capital stock" may be "capital committed." The term "shareholders' capital" or "shareholders' advances" has much to commend it.

A share of stock thus represents two things, first, a receipt for a certain sum paid in; second, the measure of the holder's proportionate fixed interest in the ownership of corporate property from whatever source accrued and wherever found. The first of these is of transient and mainly historical interest; the second is that which gives value to the share.

§ 17. Authority for the Issue of Capital Stock

The authorization of capital stock is of the very essence of the organization of a stock corporation; it must, therefore, be found in its charter. Where incorporated by special act, the act itself contains the authorization for capital stock; if incorporated under general laws, the authority of the statute is reflected in the certificate of incorporation by the recital therein of the amount of capital stock, the number of shares into which divided, the par value of each share, and the terms of any special agreement or provision limiting or extending the interest represented by the shares or by some of them. If some of the shares of capital stock are subject to limitation or extension of interest or privilege, it must be that all shares are not equal; the capital stock then contains different classes of shares and is said to be *classified*. The purchasers of the classified shares thereafter take them subject to the provisions described in the certificate of incorporation.

A corporation cannot issue any more shares of stock than are authorized in its charter. This does not mean, however, that its original capital will be the aggregate par value of the shares issued, for while the shares express a fixed par value, they may be sold at more or less than par. The issue at a figure other than par, of stock having par value, is not supported by the theory of capital stock and its relation to capital.

It is very generally sought to prevent the issue of stock at *less* than par, by statutory enactments.

If more capital is needed at any time after the stock originally authorized has been wholly issued, the corporation must amend its charter. Also if it is desired to reduce the authorized capital stock, the charter must be amended.

The terms which we use sometimes confuse our ideas. We speak of stock being issued by the corporation, and true enough the shares are issued by it, over its seal and signatures of its officials. It is perfectly clear, however, that the corporation can have no control whatever over the interest in its own proprietorship; that is a matter which can be controlled only by the agreement of the proprietors, just as in the case of any other association or partnership. The number of partners or members and their respective interests are determined solely by the agreement of the partners or members. So also in the corporation, the members themselves must determine the number of shares in interest; they may even determine the number of members by directing that no more than one share, for instance, shall be held by one member. In the beginning the agreement is between the incorporators, who, through the certificate of incorporation, *authorize* the corporation to issue a given number of shares; the corporation acts as an agent, practically, although with discretion and judgment as to times of issue, etc. Every one becoming a stockholder will be supposed to have had full knowledge of the agreement and to have assented thereto to the extent that the authorized number of shares may be issued without his consent being specifically required; when the authorized shares become exhausted, however, the stockholders themselves must decide whether they will permit an increase in the number of interests, and the conditions under which the new members will be admitted. The corporation itself, its officers and directors, cannot accomplish that result; it takes the whole body of the stock membership to bring it about.

§ 18. Par Value of Capital Stock

The par value most generally assigned to shares of stock is \$100, but shares of \$10, \$25, and \$50 are not uncommon. Statutes permit a great deal of latitude; the New York law fixes a minimum of \$5 and a maximum of \$500. In some continental countries, especially Germany, the minimum par value is placed much higher, with the apparent purpose of restricting investment in shares to men of means who presumably will be better able to suffer a reverse should the corporate enterprise fail.

In view of the great amount of discussion which has taken place concerning the utility of expressing a par value on shares of stock, it is necessary to emphasize the fact that it was originally merely an incident of dividing the total capital stock into equal parts; the practices and theories which have since grown up around it and brought its utility into question are not the necessary results of expressing a par value.

In recent years the device of stock without a par value has been introduced. The capital stock is still divided into shares, and an amount at which the shares will be offered for sale must necessarily be determined beforehand. To the extent that this amount represents the value assigned to the share for purposes of issue, it corresponds to the par value, but it will not appear at all upon the certificate of stock, as the expressed par value would. The utility of the device is discussed in §§ 36-38.

§ 19. Certificates of Stock

Capital stock represents proprietorship, and the certificate of stock is the record of the shareholder's title and the evidence of his right; it is merely evidence, however, and is not at all essential to the creation or maintenance of the relationship. A person becomes a stockholder when he purchases or agrees to purchase, or otherwise becomes entitled to receive, shares of stock. Thus, the purchase for cash of a share of

stock, or the rendition of services or the transfer of property pursuant to an agreement to accept payment in shares of the capital stock, is sufficient to vest in the purchaser or the acceptor of the shares all of the rights of a stockholder.

The certificate of stock is usually quite an elaborate document, printed, lithographed, or engraved upon a good quality of paper to stand the handling, folding, and unfolding incident to its use.¹ The name of the issuing company, with a note as to the state wherein incorporated, the total amount of the authorized issue of which the certificate evidences a part, the class of stock (i.e., preferred or common) if the company has more than one class authorized, and the par value of each share are all stated upon the certificate. The certificate then certifies, over the seal of the company and the signatures of its proper officers, that the person named therein is the owner of the stated number of shares of the capital stock of the company. It also bears a statement of the conditions under which transfer will be recognized by the corporation. A blank form of assignment to be used in transferring the stock appears upon the back of the certificate.

These are the essential recitals; other provisions may be added to take care of special conditions; for instance, if any special conditions of preference attach to a certain class of stock, they will be fully set forth. The form of the certificate is not material. A certificate of stock written out by hand or typewritten will be just as good as the most elaborate document. In ordinary practice the certificates are printed in blank form, and bound into a stock certificate book, each certificate attached to a stub which will remain bound in the book after the certificate is detached therefrom. The stub is for the record of the serial number of the certificate, the amount for which it was made out, date, name and address of stockholder, and if the certificate was made out to transfer the

¹ Certificates of stock listed on the New York Stock Exchange are required to be engraved.

interest of a former stockholder, it shows the name of the transferor as well; it will also provide a form of receipt to be signed by the transferee.

The identical relationship evidenced by the certificate of stock may sometimes be expressed by a less formal instrument of temporary nature, as, for instance, temporary stock receipts which are issued before the blank forms for the certificates have been prepared. The general recital of these receipts is of like tenor with that of the certificates and they are similar in form and transferable in like manner. As soon as the certificates have been prepared, the receipts are exchanged for the formally executed certificates of stock.

Another form of a temporary stock receipt is that issued when stock is purchased by subscription and but a part of the agreed price is paid; the purchaser does not receive the certificate of capital stock until it is paid for in full, but upon the payment of each instalment he receives a receipt.

§ 20. Issue of Stock

A share of stock is issued when a person becomes entitled to the rights and privileges of a stockholder by performing the conditions required of him. The corporation must have offered shares of stock for issue, and the one desiring shares to be issued to himself must pay the amount required at the place, and in time and manner specified; he then becomes a stockholder, although he may not receive a certificate of stock until some time afterwards.

The certificate is executed when it has been filled out with the name of the stockholder, and all the necessary signatures of the corporation's officers, together with the corporate seal, have been lawfully affixed.

The execution of the certificate need not correspond to the date of issue of the shares represented thereby; it may precede the date of issue. For instance, a certificate may be executed and placed in escrow pending the fulfilment of some

further condition by the purchaser; when it is finally delivered it will indicate that all requirements have been met, so that the stock is issued simultaneously with the delivery of the certificate. Execution of the certificates may also follow the date of issue, and very often does.

To distinguish between the issue of capital stock and the ministerial act of executing and delivering the certificates, the New York Public Service Commissions, in the forms prepared for annual reports of corporations, adopted the phrase "actually issued" concerning the former, and "nominally issued" concerning the latter. These terms are defined as follows:

"Actually issued securities are those which have been delivered to and accepted by a bona-fide purchaser for value. Where there is a binding agreement between the corporation and such purchaser whereby the corporation becomes bound to deliver and such purchaser becomes bound to accept the securities, and all terms have been settled and agreed upon, and such purchaser has been accepted and is treated by the corporation as a security holder in respect of such agreement, and all evidence required by the Statute of Frauds has been provided, the case may be treated as one of constructive delivery even though the paper evidence has not yet been turned over to the said purchaser. A pledgee taking securities as collateral is not to be considered a bona-fide purchaser for value, as the phrase is above used with respect to such collateral, until after forfeiture of the pledge or its acquisition under foreclosure proceedings.

"Where papers which are securities in form have been prepared with the purpose of issuing them to bona-fide purchasers for value, in the preparation of which papers all necessary entries, signatures, sealings, and certifications by trustees have been made, but the papers have not yet been actually issued (as defined in the preceding paragraph), they are called '*nominally but not actually issued.*'"

After stock has been issued, the corporation is required by law to record the names of the stockholders in a stock book and the detail in which the information for this book must be recorded is sometimes specifically described in the statute. In New York it is required that the book shall contain, alphabetically arranged, the names of all stockholders, their places of residence, the number of shares held, date when they became the owners of those shares, and the consideration paid. This book is required to be kept open daily, during three business hours at least, and may be inspected by stockholders and judgment creditors. Record in this book forms the basis upon which the corporation will recognize its stockholders. Those who are listed therein are the "stockholders of record."

In the above definition of "actual issue" the reference to the Statute of Frauds may require some explanation. The Statute of Frauds, so called, is a series of statutory provisions requiring certain contracts to be in writing in order that they may be enforceable at law. Apparently the provision here referred to is the one requiring a contract to be in writing if it relates to the sale of personal property for the price of \$50 (the New York limitation) or over, except where the contract is partly executed by part payment or delivery of the subject matter of the contract. The courts of this country have generally held that shares of stock are includible in "goods, wares, or merchandise," for the purpose of giving effect to the provisions of the Statute. Where subscriptions must be made in conformity with requirements of the stock corporation laws, these provisions of the Statute of Frauds will be inapplicable.

§ 21. Payment for Shares of Stock

It is of the essence of the relationship between the stockholder and the corporation that the former shall have contributed some definite form of capital to the proprietorship of the corporation. In the case of stock having par value, that

stands as the index of the contribution made by each stockholder; hence the general theory that stock must always be issued at or above par, more fully discussed in Chapter IV.

The payment of the stockholder may be made in cash or in some other form of consideration, such as the rendition of services or the turning over of property having actual determined value equalling the amount of the contribution to be made. The matter has been generally subjected to statutory enactment. The New York statute as to payment of stock reads as follows:

"No corporation shall issue either stock or bonds except for money, labor done, or property actually received for the use and lawful purposes of such corporation, and may issue stock to the amount thereof in payment therefor, and the stock so issued shall be full paid stock and not liable to any further call, neither shall the holder thereof be liable for any further payment under any of the provisions of this chapter; and in the absence of fraud in the transaction the judgment of the directors as to the value of the property purchased shall be conclusive; and in all statements and reports of the corporation, by law required to be published or filed, this stock shall not be stated or reported as being issued for cash paid to the corporation but shall be reported as issued for property purchased."

A number of states have carried similar provisions into their constitutions, while others have enacted more or less specific laws. The Constitution of the State of Delaware, for instance, provides that "no corporation shall issue stock, except for money paid, labor done, or personal property, or real estate or leases thereof actually acquired by such corporation."

Payment other than in cash is permitted by statute solely to avoid the necessity of first issuing the stock for cash and then turning over the proceeds to the purchaser of the stock in payment for services rendered or property transferred by him; obviously, therefore, to make a transaction bona-fide,

the services rendered or the property transferred must have been such as the corporation would in any event have found it necessary to obtain. Nevertheless, the dual relationship of the parties, each being at the same time both vendor and vendee, may affect the judgment as to the value of the property or services, and give occasion for practices prejudicial to the interests of others, as is more fully described in § 28. The danger has been considered so great that in some European countries the privilege of making payment other than in cash has been restricted or subjected to special regulation.

In the absence of a specific contract as to method of payment, it must be made in actual legal tender to be effective. It may not be made by promissory note in whole or in part. In New York as well as some other states this prohibition is carried into the statutory law; a provision of the Penal Law of New York (Section 644) makes it a misdemeanor for a director to concur in any vote by which it is intended "to discount any note or other evidence of debt in payment of an instalment of capital stock actually called in, and required to be paid, or with intent to provide the means of making such payment; or to receive or discount any note or other evidence of debt with intent to enable any stockholder to withdraw part of the money paid in by him on account of stock." To permit payment by note would open the door to many abuses of corporate finance.

Stock is said to be "full-paid" when the holder thereof has paid in, in cash or other agreed form of consideration, an amount equalling the par value of the stock. Under proper conditions, e.g., pending completion of subscription, stock may be issued and remain outstanding although not paid for in full, but so long as it is thus outstanding the holder is subject to call of the directors of the corporation, or the demands of creditors made through proper judicial proceedings, for the balance due.

§ 22. Subscriptions to Capital Stock

Stock is subscribed for "where there is a binding agreement between the corporation and such purchaser whereby the corporation becomes bound to deliver and such purchaser becomes bound to accept the securities, and all terms have been settled and agreed upon, and such purchaser has been accepted and is treated by the corporation as a security holder in respect of such agreement."¹ In other words, contracting to purchase shares of stock of a corporation (upon original issue, of course, as distinguished from the sale and transfer of shares of stock from one stockholder to another) is to subscribe to an issue of capital stock. It should be noted that a subscription contemplates a sale and purchase; a mere promise to accept stock in payment of services or property does not constitute a subscription.

A subscription is distinguished from an attempt to purchase by the tender of promissory notes in that the subscriber's shares are admittedly not paid for in full and he holds forth his personal liability for the balance, in default of which he would forfeit the amounts already paid in and cease to be a stockholder; moreover, his liability is for payment of the balance or some specified part thereof on call, unless otherwise agreed, so that the corporation may realize thereupon at any time. A purchaser of stock who comes into possession of shares by the tender of a promissory note, on the other hand, if the transaction were permitted to be valid, would become the owner of the shares absolutely, his only liability being upon the note. If he failed to pay this, the remedy against him would be through action upon the note and satisfaction through execution, the shares owned by him being subject to execution only as any other class of personal property owned by him, provided such shares were still in his possession; he could dispose of the shares at any time before

¹ From definitions contained in report forms of Public Service Commission, Second District, New York.

judgment and transfer valid title. Unlike the liability of the subscriber, the liability of the debtor stockholder cannot be realized upon by the corporation until the note falls due, unless it were a demand note.

Stock may be subscribed for before or after incorporation, and usually any agreement which indicates clearly an intent to become a subscriber will be sufficient, in the absence of statutory regulation. Certificates of incorporation are very often required to state "the name and post-office address of each subscriber to the certificate and the number of shares of stock he agrees to take." When such a statement has been prepared it will be sufficient to create a stockholder's relationship between the corporation and the persons named, to the extent of the number of shares entered against their names. A contractual liability to purchase and pay for the stock is imposed upon each person thus signing the certificate. This liability becomes effective, of course, only upon the due filing of the certificate.

Preincorporation subscriptions are not generally regulated by statute. In the early days of railroad corporations there were many instances where commissioners were appointed to receive preincorporation subscriptions. If there are two or more subscribers, the subscription of each will be the consideration for the subscription of the others so as to make the contract enforceable among themselves and, as a rule, they can be held to the agreement by the corporation. In New York, however, if the contract is to be also enforceable by the corporation as a party to the contract, it is necessary that the agreement of the subscribers be to subscribe to a number of shares of stock *and to form a corporation*. If the express intent of forming a corporation is not stated in the agreement, the corporation upon coming into existence is deemed a stranger to the contract and may not itself sue to recover upon the agreement, although undoubtedly the subscribers who carried out their contract may maintain action against

those committing a breach, provided the former had relied upon the subscriptions of the latter and had incurred liabilities accordingly. To permit recovery by the company, formal subscription after incorporation is necessary.

Subscriptions made after incorporation must conform to the method prescribed by statute. The New York statute provides that: "At the time of subscribing, every subscriber, whose subscription is payable in money, shall pay to the directors ten per centum upon the amount subscribed by him in cash, and no such subscription shall be received or taken without such payment."

The contract of subscription may specify each date when further payments are required to be made; if there is no specific provision, further payments will be due as and when "called" by the board of directors.

§ 23. Transfer of Certificates of Stock

Transfers of stock may be made at the corporate office, where some officer, generally the treasurer or an assistant treasurer, issues new certificates for the old ones when presented. Corporations having large issues of capital stock outstanding, the shares of which are heavily dealt in on the market and changing ownership frequently, will appoint some person, banking house, or trust company as transfer agent, deposit with him the book of blank certificates and the corporate seal, and authorize him to make transfers of stock by issuing new certificates for the old ones upon presentation. The blank stock certificates deposited with him are properly signed by the treasurer and president or vice-president of the corporation, but they do not become valid unless countersigned upon issue by the transfer agent and sealed with the corporate seal.

Corporations issuing "registered stock" also provide a registrar whose countersignature is likewise necessary to the validity of the certificate. Registered stock differs from the

ordinary stock in that upon transfer of the certificate, in addition to the signature of the owner on the back of the certificate, his signature (made personally or by one authorized to sign for him) is also necessary on books maintained for that purpose by the registrar.

Shares of stock are evidences of interest or right, and they may be transferred by assignment in writing. A blank form of assignment is usually printed on the back of the certificate, as a matter of convenience. To transfer any part or all of the shares represented by the certificate, the holder thereof fills in the name of the transferee, specifying the number of shares to be transferred, and, having had his own signature witnessed, sends the certificate to the transfer agent. He may also name some person as his attorney³ for the purposes of transfer, in which case that person must appear in person to request the transfer; usually this space is left blank and the transfer clerk will then insert his own name. The transfer agent must cancel the returned certificate and in place thereof issue to each transferee a certificate for the number of shares ordered, and if the total number of shares represented by the original certificate returned to him is not to be transferred, he executes to the owner a new certificate for the number of shares retained. The transferees thereupon become stockholders of record and their names are entered upon the stock book.

If the holder of the certificate does not specify the name of any transferee, he is said to have transferred in blank and the certificate may pass from hand to hand without the necessity of a new one being issued each time. Any holder may, of course, fill in his own name and present the certificate for transfer on the records. It must always be remembered that the holder whose name appears upon the record is the one recognized by the corporation and if any dividends are de-

³ Such a person need not be a lawyer; the term here refers to an attorney-in-fact, i.e., one acting as the agent of another in the doing of a particular act.

clared in the meantime these will be paid to him. The dividends, of course, really belong to the actual owner of the shares who may demand them from the stockholder of record, but the owner of the shares will not be entitled to demand payment from the corporation without first having the transfer recorded. On the other hand, if the corporation fails under circumstances which impose a liability upon the stockholders, the holder of record will be liable even though he is no longer the owner of the shares.

The certificate itself calls attention to the necessity of transfer upon the books, in its recital that the shares represented are "transferable only on the books of the company, in person or by attorney, on surrender of this certificate." It is not to be forgotten, however, that as between the transferor and transferee, the transfer is valid and effective to pass title upon delivery of the certificate properly indorsed. The transfer upon the books is for the protection of the corporation, and to relieve the transferor of liability as a stockholder to the creditors of the corporation.

An agreement among all the stockholders limiting the right of transfer will be binding; such a limitation may be placed in the certificate of incorporation or covered by separate agreement. In every case, however, the limitation must be reasonable and it must not amount to an absolute restriction; the courts are careful to guard the transferability of the shares, for this represents a valuable and essential characteristic of corporate organization.

Shares of stock are the personal property of the owner which he may dispose of as he will, and the corporation or its transfer agents are bound to make the transfer and recognize the transferee as a stockholder, in the absence of any legal restraint operating upon the corporation and permitting it to refuse record of the transfer. The Public Service Commissions Law of New York, for instance, describes certain conditions under which one public utility may not become a

stockholder in another without the consent and authorization of the Commission; to make this prohibition effective, it further provides that the corporation whose stock is the subject of the prohibited transfer shall not record the transfer upon its books and shall not issue certificates of stock therefor.

When payment of a tax is required upon transfers of shares of stock, it must be paid before transfer can be recorded upon the books; moreover, the corporation is required to keep such record of the transfers as will enable the state authorities to check up payments. The New York statute requires every corporation to keep a stock certificate book and a just and true book of account, transfer ledger or register, in such form as may be prescribed by the comptroller, wherein shall be plainly and legibly recorded in separate columns the following:

- "1. The date of making every transfer of stock.
2. The name of the stock and the number of shares thereof.
3. The serial number of each surrendered certificate.
4. The name of the party surrendering such certificate.
5. The serial number of the certificate issued in exchange therefor.
6. The number of shares covered by said certificate.
7. The name of the party to whom said certificate was issued.
8. Evidence of the payment of the tax provided for (i.e., the number and face value of the stamps affixed)."

Surrendered or cancelled certificates and all other records or memoranda relating to sales or transfers must be kept for a period of two years at least, under the provisions of the New York statute.

⁴ Consolidated Tax Law, Section 276. The tabular arrangement is here used for convenience; it is not found in the original.

§ 24. Certificates of Stock as Negotiable Instruments

The ease with which certificates of stock are transferred, and the many uses made of them in ordinary commercial transactions sometimes give the suggestion that they are negotiable paper. The significant characteristic of negotiable paper is that it can be transferred by delivery or indorsement and the transferee will acquire good title, provided all the conditions prescribed by statute obtain, irrespective of any defect of title in the transferor. Such an instrument, however, is required to contain an unconditional order or promise to pay a certain sum of money, and certificates of stock are not securities for money; they do not represent a debt and cannot, in the very nature of the case. However, although they do not technically become negotiable instruments, stock certificates have been assigned a great degree of negotiability, and "innocent parties dealing in them will be protected upon analogous principles, and, in a proper case, will be entitled to compel recognition as stockholders, where power exists to issue new certificates, or to indemnify if there is not."⁵

"Certificates of stock are not negotiable in form; they represent no debt and are not securities for money; but the courts of this country, in view of the extensive dealings in certificates of shares in corporate enterprises, and the interest both of the public and of the corporation which issues them in making them readily transferable and convertible, have given to them some of the elements of negotiability."⁶ In legal phrase, they are *quasi* negotiable.

An essential requirement of notes which are to circulate as negotiable instruments is that they must be payable to bearer or order, and correspondingly, to enjoy the greatest measure of negotiability of which they are capable, certificates of stock must also be made payable to order or bearer. The form of the certificate itself does not permit of this, and the

⁵ *Jarvis v. Manhattan Beach Co.*, 148 N. Y. 652.

⁶ *Knox v. Eden Music Co.*, 148 N. Y. 441.

only way in which this can be accomplished is by indorsement in blank.

"While certificates of stock do not possess, in full, the quality of commercial paper, yet when the transfer indorsed thereon is signed in blank by the shareholder named therein, they become, so far as the public is concerned, as if they had been issued to bearer."¹

In England and the United States, "bearer shares" are not customary, in fact, they are not provided for by statute, while in Germany, France, and other continental countries they are quite usual. "Bearer shares" correspond in form to our coupon bonds. Shares of stock corresponding to the form of our ordinary certificates are known in those countries as "nominative shares," or the two forms are sometimes distinguished by calling the one "shares to name" and the other "shares to bearer." Bearer shares can be freely negotiated without transfer on the books of the corporation, so that the holders of the shares are not known to the corporation until the coupons attached to the shares have been presented for the payment of dividends declared. Bearer shares may be converted into nominative shares and vice versa.

The Uniform Stock Transfer Act, so called, enacted with slight changes by a number of the larger states, describes the warranties of the transferor of stock. In New York these provisions are carried into the Personal Property Law and the particular section (172) reads as follows:

"A person who for value transfers a certificate, including one who assigns for value a claim secured by a certificate, unless a contrary intention appears, warrants—

- (a) That the certificate is genuine,
- (b) That he has a legal right to transfer it, and
- (c) That he has no knowledge of any fact which would impair the validity of the certificate.

¹ Fifth Ave. Bk. v. Forty-second St. and Grand Ferry R. R. Co., 137 N. Y. 231.

"In the case of an assignment of a claim secured by a certificate, the liability of the assignor upon such warranty shall not exceed the amount of the claim."

§ 25. Shares of Stock Taxed as Personal Property

Shares of stock are choses in action, representing an incorporeal right vested in the owner of the shares; they are thus considered as personal property even though the corporate assets, ownership whereof is represented by the shares, may consist wholly of real property.

It is well established that shares of stock may be taxed as personal property of the stockholder. The exercise of the power to tax, however, is subject to many considerations of equity and fairness. In spite of the distinction between the stockholder's property rights in the shares and the corporation's property rights in the corporate assets, the taxation of shares must be considered as but one aspect of the general problem of taxing corporate properties and enterprises—as complicated a problem as may be found. There are many methods of levying taxes upon corporations. There are always the usual taxes on realty and personalty owned by the corporation. Then the corporate franchise may be taxed; so also the income or profits, or else the levy may relate to the capital stock (the tax to be paid by the corporation), or to the shares of stock in the hands of stockholders and to be paid by them individually; or, again, the shares of stock may be taxed, payment of the tax being made by the corporation in the first instance and in turn collected from the stockholders.

Taxes levied upon shares of stock must not be confused with taxes upon the capital stock. It has been held that a tax upon the capital stock is actually upon the property of the corporation, placing a somewhat different meaning upon the term from that usually assigned to it; it has been further held that this remains true even though the value of the capital stock for purposes of taxation is taken as the aggregate of

the value of the shares. To distinguish a tax upon the shares, it is said that the legal property of the shareholder is entirely separate and distinct from the property of the corporation even though the value of the former depends upon the value of the latter.

The chief objection to the exercise of the right is that it almost inevitably results in double taxation which is not favored either in law or economics. The state has the right to levy double or even treble taxes, but unless it is a measure of emergency the levy of such taxes is considered an abuse rather than the proper use of authority, and in some instances, therefore, states seek to prevent double taxation by constitutional limitations. The danger can be obviated only by deducting from the taxable value of the shares the taxed value of the corporate properties; the excess is then regarded as the untaxed intangible value of the stockholders' interest. The same principle holds true in the taxation of capital stock, where it is easier of operation. There are perhaps not more than four states which assess shareholders wholly irrespective of other corporation taxes; these are Delaware, Georgia, Louisiana, and Washington. Maryland, the District of Columbia (in a measure), Alabama, and Iowa assess shareholders on that part of the value of their stock which represents the excess of market value of the shares over the assessed value of the corporate properties. In all other states shares of stock are not assessed against the stockholders when the issuing corporation or its property is directly taxed. The New York statute provides that "the owner or holder of capital stock in an incorporated company liable to taxation on its capital shall not be taxed as an individual for such stock."

Personal property follows the domicile of the owner; thus, a state acquires the right to tax the shares of stock of a foreign corporation when held by a person residing in that state. It would therefore seem that the state wherein the corporation was incorporated would lose the power of taxing

shares in that corporation if they were held by persons residing in other states, but on this point it is held that the common law rule which permits personal property to follow the owner can be amended by statute in respect of shares of stock so that the situs of the shares may be fixed, for the purposes of taxation, at the location of the corporation. The method of collection under the latter circumstances is that of collecting the tax from the corporation and empowering it to collect from the stockholders.

Upon organization of corporations most states collect a tax upon the authorized capital stock, collecting a similar tax upon future increases. This tax should not be confused with the annual tax upon capital stock, where one is levied.

CHAPTER IV

RELATION OF PAR VALUE TO PRICE OF ISSUE AND VALUE OF STOCK

§ 26. Capital Stock to be Issued at Par

The logical and necessary consequence of the general theory of capital stock issues discussed in the foregoing chapter is that shares of capital stock must be issued at par. If there has not been complete compliance with that requirement there has not been that initial identity between capital and capital stock which should have characterized the first stage in the development of the corporate enterprise. In theory that identity begins to be destroyed almost the very instant that it is established, for capital is subject to constant change, while capital stock continues to be held forth as the measure of that original equality—if the enterprise has not been conducted at a loss it will also represent the minimum of the corporation's equity, i.e., the excess of its assets over the liabilities (capital stock itself not being a liability); if it has been conducted at a loss, capital stock will serve to measure, by the comparison between the corporation's present equity and its own par value, the impairment of original capital.

Significance of Par Value of Outstanding Shares. But, after it has served its original purpose of establishing the price of issue, is there any real reason why the capital stock should continue to be stated at par value? The corporation is under no obligation for the par of the stock to the stockholders or to anyone else. The stockholders' interest is that of proprietorship, the value of which is a fluctuating amount; carrying the stock at par does not make it any easier to determine that value, but in fact makes it more difficult. It is a

fact not generally pointed out that the appearance of capital stock at par upon the balance sheet, when other figures necessary to the computation of the real amount of proprietorship are scattered under various designations, has been the means of more misinformation as to the real value of the stock than perhaps all the misstatements of those interested in hiding the facts.

From the viewpoint of the stockholders one reason for carrying stock on the books at par is that the original issue of the stock represented investments made by those who purchased the shares. A basic principle of investment is that the amount put out shall be income-producing during the period of investment and be returned undiminished at the expiration of that period. Accordingly it may be contended plausibly that the par value, representing the original investment of the stockholders, shall be carried continuously as a historical fact, so that by comparison with other facts a conclusion may be reached as to the fidelity or success with which the corporation is administering the stockholders' investment. Another reason is that the amount of proprietorship may be increased either by the profits retained in the business or by the payments on new issues of stock; in the first situation the value of each share of stock is increased, while it is not necessarily affected in the second situation. Neither of these reasons, however, is such as to require imperatively the carrying of stock at par upon the current books of the corporation. Memorandum entries could easily be made to suffice.

Where there is an issue of stock preferred as to principal, so that upon distribution of the corporate assets it will be entitled to receive its par value before the common stock may be allowed to participate, then the current record of the par value of the preferred stock becomes a matter of importance.

The "Trust Fund" Theory. Apart from the stockholders' interest, the par value of the stock has been taken as the index

of the corporate financial responsibility—the basis of credit, so that the rights of creditors may be said to be violated if the capital stock has been issued under circumstances which have withheld from the corporation the full measure of capital intended to be represented by the par value thereof. This is the “trust fund” theory, holding that the capital stock represents a fund provided and maintained for the protection of creditors. Evidence as to the condition of the trust fund is thus considered to be essential information for the guidance of creditors. The “trust fund” theory as the basis of determining the legal status of stock is no longer given effect, but during the period when it was operative it caused the adoption of practices which have since continued. It is well to note in passing that credit, both personal and corporate, depends as much, if not more, on a record of achievement as it does on the possession of valuable property assets, and the one who is to extend credit to the corporation is very much interested in noting the extent to which the corporation has been able to maintain the integrity of the stockholders’ investment.

Limited Liability of Stockholders. Stockholders are not liable for corporate debts beyond the par value of the stock, and if the par value has been paid in, creditors (except employees for wages remaining unpaid after judgment and execution against the corporation) have no recourse against the stockholders. The sole purpose of incorporating a very large number of more or less personal enterprises is that of securing for the owners thereof the protection of the limited liability thus provided by law. If the benefits of the law are to be taken advantage of, its obligations also must be assumed; hence the general rule of law, even in the absence of specific statutory requirement, that capital stock, if it is to be “full-paid” so as to relieve the holder from further liability, must be issued at not less than par. A person purchasing it at less from the corporation on original issue, whether under secret

agreement or by direct resolution of the board of directors of the corporation authorizing the issue, will be deemed in the theory of the law to have accepted the stock subject to an agreement to pay the difference between the purchase price and the par value should the claims of creditors require the deficiency to be made good. Moreover, the state may institute proceedings to forfeit the charter of the corporation, provided some public interest has been jeopardized. This is a very general statement of the rule and its practical application causes many modifications and qualifications. For instance, in some states a stockholder receiving stock as bonus is liable upon a proper demand for payment, while in New York and other states a different principle is applied. The basis of the New York rule is that the issue of stock is a contract, and if it has been issued at less than par the court cannot later amend the contract so as to require the stockholder to make a further payment which he never agreed to make; the remedy is that of ordering rescission, and, following the rules of contracts, both parties are to be restored to their original position as nearly as may be, viz., the property or value given by the stockholder must be returned to him, and the stock issued by the corporation or the value thereof must be returned by the one who received it. The presence or absence of fraud, the knowledge on the part of those extending credit that the stock had not been issued for full value, and any number of special considerations will affect the operation of the rule in specific cases.

Issue at Par to Avoid Inflation. Capital stock issues are sometimes described as mediums of credit, so that the issuance of the stock at less than par would represent the inflation of credit and involve the possibility of the same ultimate results should the credit collapse. Supposing that upon the failure of the corporation the stockholders were the same as those to whom the shares were originally issued, their loss would not be any more or less because of the par value speci-

fied in the shares, but would be measured solely by the actual amount of their investment. The situation would be far different, however, if the shares originally held by these stockholders had been transferred and retransferred, each succeeding holder paying a higher price than had his predecessor, more nearly approaching if not exceeding par. The investment of the stockholders at the time of the failure would then be greater than the investment of the original stockholders as represented by their contributions to the corporate capital. The contention of those who follow this theory, that stock be issued at par, takes into consideration incidents in the life of the shares after the original issue—an eminently proper consideration.

§ 27. Watered Stock

Stock which purports to be full-paid but which is actually issued for no direct consideration or for a consideration much less than par is said to be “watered”—the corporation is overcapitalized; it has outstanding more certificates of capital-contributions than it has capital. Overcapitalization may also result from the inflation of capital-indebtedness. The problems arising from both conditions closely resemble each other.

The problem of watered stock has always been a perplexing one. The practice has been generally condemned; it has been repeatedly attacked; it has been legislated about and sought to be legislated out, but not only does it continue to remain with us but it is still able to find its champions and advocates and the recent trend towards allowing the issue of stock at discount must be admitted to be a recognition, in some measure at least, of the justice of some of the arguments which have been adduced in justification of the practice.

Stock-watering appears in many forms, e.g., in the issue of stock as bonus to purchasers of bonds, in “stock dividends” based on superficial valuations, in the issue of an insufficient consideration consisting of property or services to which a

fictitious value is assigned, and even for a cash consideration representing but a fraction of the par value.

The facility with which stock may be transferred to others has been a great source of temptation to "water" it. The person acquiring a block of shares for practically nothing or for a very small consideration can turn around and sell his shares to others who rely upon the presumption of par value approximating original investment. He may thus realize exceptionally large and quick profits, and at the same time divest himself of all interest in the corporation and transfer to others the burden of making up the deficiency, while he would not, except in an especially unconscionable transaction, be answerable to those he has induced to purchase the stock. True, the purchaser may be cunning or clever enough to protect his own larger investment by placing upon the customers of the enterprise the burden of paying charges sufficient to compensate him, but it would simply postpone the day of reckoning, unless, happily, he were willing to put back into the enterprise enough of his profits to make up the original deficiency.

Stock is seldom "watered" by an issue for cash at less than par, because the facts would be too obvious. Instead, methods have been devised which command the semblance of legality while affording sufficient opportunity to disguise the true nature of the transaction and to make proof of fraudulent intent difficult.

§ 28. (1) Stock Issued for Property or Services

The most common device for watering stock is to issue stock for property or services. This has proved exceptionally convenient, not only because the statutes expressly permit the exchange for property or services, but also because they make conclusive the judgment of the directors as to the value of the properties accepted in exchange, provided, of course, there is no actual fraud. Where the directors represent the promoters or the controlling stockholders who are also interested

in the sale of property to the corporation, the determination of those directors as to the value of the property is apt to rest solely upon the statements, or be responsive to the desires, of those who have placed them in office. Their judgment being made conclusive, they may act with impunity, for their findings can be impeached and their acts invalidated only upon proof of actual fraudulent intent—a matter difficult of ascertainment and proof in ordinary circumstances and made doubly so through the great care taken to create the semblance of a bona-fide transaction. Especially where the value of the property involved is uncertain and fluctuating, or where there can be no fixed standard of value save the judgment of those who deal with it, with a possibility of as many estimates of value as estimators, it is very difficult to prove that, even were the property accepted at double the actual worth, the overvaluation was not due to an honest mistake in judgment but rather to deliberate intent to commit fraud.

The rule is well settled that an honest mistake in judgment will be insufficient to vitiate a transaction, and that actual fraud must be proven, although fraud may be presumed as a matter of law in flagrant instances of gross overvaluation. Just where the plea of honest mistake will be overcome by a presumption cannot be definitely stated, but the property accepted must have possessed at least a certain tangibility of value to support the plea. A non-patented and non-patentable idea, for instance, has been held to have no such value as to protect the issue of stock in exchange therefor.

Property is not deemed to have been accepted at an overvaluation on the mere ground that, by the test of subsequent events, it is shown to possess a value less than the face of the stock, and fraud cannot be presumed from the fact that property exchanged for stock possesses a value fluctuating, uncertain, and difficult of exact measurement. Inquiry is directed to the question of whether at the time of the directors' determination the property had, or under all the circumstances

could reasonably have been deemed to have, a value equalling the par value of the stock issued.

§ 29. (2) Statutory Restraints on Watering Stock

Legislation which seeks to restrain the practice of over-valuation of property should be so designed as to give adequate protection to bona-fide stockholders, creditors, and the public, against those who would resort to the practice for their own undue profit. If corporate enterprises are to be encouraged, investors must be placed in a position to be informed correctly and authoritatively of all the facts so that they may arrive at proper estimates of value. Then, one who purchases shares of stock knowing the facts surrounding the original issue and being cognizant of the defects therein, cannot complain later if he suffers loss or is required to make up a deficiency of the original investment because of the improper organization of the corporation. However, where he cannot know the facts, it is manifestly unfair to make the bona-fide stockholder responsible for the deficiency in the original investment, unless he is given the full assistance of the law in attempting recovery from those who profited by his ignorance. Similarly, creditors are entitled to full knowledge of all the facts affecting the basis of credit and should be enabled to seek remedy against some responsible party if they suffer loss through the suppression of facts. Over and above the limited interests of the creditors, there is the wider economic interest of the community at large in the maintenance of financial integrity. Then there is the more immediate public interest which requires of public service corporations that only such charges and rates shall be imposed as will be fair and just upon the basis of the capital invested and necessary to render the particular service demanded. Accordingly, legislation has advanced along two main lines, the one seeking to make issues bona-fide by eliminating personal interest or bias in the determination of value of property or services accepted as pay-

ment; the other seeking to give publicity to all the details affecting the organization of the corporation and its financial transactions.

Statutory Restraints in European Countries. The experiments of some European countries in this matter are interesting. The French law recognizes two classes of stockholders—those paying for shares in cash and those paying in other forms of consideration. The latter are subject to provisions limiting their possible influence in the determination of value; for instance, they may not participate in any action determining the value of the property to be accepted as payment; that value is to be determined by the stockholders who have paid cash for their shares, and who act upon the report of valuation experts. The most important provision, however, is that which suspends the negotiability of vendor's shares for a period of two years after complete organization of the corporation, during those years making the present, intermediate, and original vendor-shareholders jointly and severally liable for the balance unpaid upon the shares. This is a measure intended to restrain promoters from issuing large blocks of shares to themselves for insufficient value and with the sole expectation of realizing immediate profits by their sale; it is also intended to protect creditors by giving them recourse against the original or intermediate holders should their present successors prove irresponsible. Even with these ingenious provisions, however, it is said that the French law has not succeeded in eliminating the influence of controlling stockholders in the determination of value.

The German law also recognizes two classes of stockholders and provides for a "qualified" organization in instances where stockholders have been permitted to make payment other than in money. It is sought to procure the elimination of personal interest by requiring that the necessary certificate of proper organization to be made by the organizers shall, in the case of a "qualified" organization, be also certified to by

auditors appointed by the official board of trade of the district or by the court; the aim here is that of assuring a disinterested investigation. Persons paying for their stock other than in money are regarded as, and subjected to, the special responsibilities imposed upon organizers. In some ways the provisions regarding the duties and responsibilities of stockholders of the two classes resemble the provisions of the French law; the German law, however, lays somewhat greater emphasis upon publicity. Among the papers necessary to be filed to complete the proper organization of the corporation must be included a declaration setting forth all of the circumstances surrounding the acceptance of a consideration other than money for the stock. The main criticism which has been levelled at the German law in these respects is that its elaborateness operates to bury necessary facts rather than to expose them, thus defeating the very ends it is intended to serve.

Publicity is the basis of the English legislation in this respect; it seeks to protect investors and creditors by putting in their possession a correct and trustworthy statement of all the incidents of the proposed issue, and then leaves them free to act according to their own judgment and prudence. The Companies Act of 1900 requires the prospectus, if one is to be issued, and if not, then the statement in lieu thereof, to give the necessary details of organizers, directors, classification of stock, etc., and in addition to name all vendors of the property which the company intends to acquire in exchange for shares or debentures; it must also describe specifically the amount paid for good-will, for underwriting, and for promotion, the estimated amount of preliminary expenses, and the nature and extent of the interest of every director in the promotion of the company or in the property proposed to be acquired. Every director, promoter, or other person authorizing statements contained in the prospectus is directly liable to persons sustaining loss or damage by reason of the falsity of those statements, unless, of course, the person charged with the

falsity can prove that he himself believed the statement to be true at the time it was made and up to the time of the issue of the shares or debentures, and that there were reasonable grounds to support the belief.

§ 30. (3) Effect of Watering Stock of Public Service Corporations

In the case of public service corporations the effect of "water" in the stock upon the rates and charges of the company for service has been the most emphasized. The stockholder has invested his capital in the corporate enterprise where he expects it to be income-producing. If the exigencies of the corporation cause an impairment of the capital, he is quite unwilling to dissociate his intention in making the investment from the fact of its present status; and especially in the case of public service corporations, where the fixed capital required is so large, he has sought to maintain a more or less artificial equality between capital and capital stock. Sometimes in proposing rates and charges for service and commodities, he has put forward the amount of capital stock for a basis, rather than the actual capital in service. His unwillingness to dissociate intention from fact has been favored by the very general confusion between the par value of stock and its real value as represented by the net corporate assets. The public, for too long a period, has accepted the par value of stock as the measure of corporate investment.

"The harmfulness of excessive issues of the capital stock of corporations serving the public arises from the fact that stock of a given face value has not behind it property equal in actual value to the face value of the stock. The result is that the owners of the stock naturally assume the value of the corporate assets to be at least equal to the face value of the stock, demand an adequate return upon the same, and in the effort to secure such return both demand excessive prices for services rendered and impair and cheapen the service.

"The stock, in the natural course of business, falls into the hands of bona-fide purchasers, who buy the same upon the assumption that it is issued dollar for dollar of value. Any effort to reduce prices for services rendered after stocks have fallen into the hands of such holders is fought, as tending to impair the value of existing securities and unsettling the basis of all corporate transactions. This last trouble arises from regarding the share of stock as representing value to an amount equal to its face value. Were all stock issues for full value, this might be true for a brief interval, but in the practical course of business such equality rarely exists."¹

The Prospectus Act of England is perhaps most often referred to in this country as a desirable modification of our own laws. There have been many who have contended, however, that publicity is not enough; that its aim is merely the protection of the investor, and that it affords no remedy for the evil results of overcapitalization as affecting the public. Even as a restraint upon the propensities of promoters, publicity has been said to be inadequate. "Publicity is good," said the late Commissioner Clements,² "but publicity is not entirely adequate for those who defy public opinion as well as good morals, and there are some of them large enough, and experienced in it enough, so that publicity is not going to restrain them as it should."

Undoubtedly the most satisfactory legislation is to be found in the enactment of public service commission laws. Under these laws the corporations amenable to them are prohibited from issuing capital stock or bonds without first securing authorization from the proper commission. That authorization will be granted only after full investigation of the purposes to which the issue is to be applied, and the proper application of the proceeds will be fixed in the order of authorization. In this

¹ New York Central & Hudson River R. R. Co. and Rochester and Eastern Rapid Ry. Co., 1 P. S. C. Rep., 2nd D., N. Y. 294 (314-315).

² Of Interstate Commerce Commission, speaking before the convention of Railroad Commissioners in 1913.

manner not only is the final determination of the value at which property is to be acquired, or the amount of compensation to be paid to promoters and others for their services, placed under the scrutiny of an independent board, but also full publicity is assured, thus affording ample protection alike to the prospective stockholders, creditors, and the general public. The extent to which that protection will be adequate and effective depends very much, of course, upon the measure of discretion and wisdom exercised by the commissioners in the discharge of their duties, and upon their honesty and integrity.

§ 31. (4) Aspects of Stock-Watering Sometimes Considered Defensible

Concerning much of the legislation in the United States it is admitted that in many instances the administration of the law purposely has been made lax. It has often been felt that the strictness of the law has interfered unfortunately with the building up of railroads or the setting up of other enterprises in new communities or under especially adverse circumstances. "The very rigidity of the statute has caused the public to be negligent in its enforcement. In some cases the laws have been so drawn as actually to invite evasion, by specifically leaving it to the judgment of the directors to decide what constituted an adequate consideration for the shares. The companies have thus been enabled to represent that their stock was fully paid, when this was not the case."³

During a period of reconstruction such as that which followed the Civil War, or that which will follow the present Great War, investments in constructive enterprises will be the greatest of public needs; the same is true of communities where organized exploitation is almost essential to development. In order to commit himself to such enterprises the investor has demanded and will demand the probability of speculative profits to supplement the conservative returns which are fairly

³ Report of Railroad Securities Commission.

well assured. Public policy may wisely consider the present benefit as being worth the reward asked, and will permit overcapitalization in the expectation that the future prosperity of the company will absorb the "water." Is this anything more or less than a bargain by which the community agrees to share with the corporation the benefit which the corporate enterprise brings to it? Under a great many circumstances, may not such an agreement be no more than fair? True enough, a better method could be devised, but if the agreement is of mutual benefit, the burden of devising the method is equally apportioned between the public and the corporation.

The United States Steel Corporation affords a striking example of how the assurance of future prosperity may warrant overvaluation in the organization of a corporation. When this company was first organized its alleged overcapitalization was loudly and vigorously condemned, and no one could avoid hearing of the condemnation and learning of the alleged "water" in the stock; now some of those who predicted the most disastrous results are most anxious to buy the stock at well above par.

Undoubtedly there are instances where "stock-watering," i.e., the issue of shares in exchange for a consideration apparently less than par, should not be condemned without very careful investigation. There are instances where, for one reason or another, it becomes proper for the issuing corporation to place a constructive value upon the property to be accepted as payment. For example, the shares of stock or other securities of a bankrupt corporation are admittedly worth little, if anything; yet upon reorganization of its affairs the new corporation may issue its capital stock in exchange for the capital stock of the bankrupt corporation at par or at some figure unquestionably representing more than the present worth of the assets, and this transaction may be one of much merit in affording a basis for the continuance of operations necessary to the public welfare. Again, where the stock of a

going concern is taken over by a merging company in exchange for its own capital stock at a value exceeding the par or present value of the shares of the merged corporation, the transaction may be eminently fair if the merger is economically necessary. In such cases the deficiency is usually taken up on the books by the assignment of some "intangible" value to the property taken over. Public policy itself may thus justify it.

In connection with modern legislation relating to this subject the opinion of one who was responsible for much of the Wisconsin Public Utilities Law is of more than passing interest. Mr. Roemer, then Chairman of the Wisconsin Commission, in a letter to the National Civic Federation ⁴ expresses his convictions as follows:

The more I study and reflect upon the regulation of stock and bond issues by public authorities, the more I am inclined to the opinion that my views when I re-drafted the Wisconsin stock and bond law were unduly influenced by the prevailing prejudice against the sin of watered stock. In providing a remedy for this admitted evil, it is a question in my mind whether other evils are not already resulting from the scheme of supervision of stock and bond issues provided in our law, and in substance incorporated in your model bill, which will tend to defeat in a great measure the purpose of the act, and will also likely embarrass, in certain instances, the commission in performing its primary function of supervising and regulating the rates and services of public service corporations.

As I view the matter, the regulation of the issues of corporate securities is and must be for the benefit of the investor. . . . In authorizing the issuance of securities and directing the investment of the proceeds thereof, the state is assuming a responsibility which, in the very nature of things, it ought not to do. The state cannot direct the management of the corporation, and therefore, should not undertake the responsibility of authorizing the issuance of securities and directing the investment of their proceeds. By so doing it is likely to

⁴ Reprinted in proceedings of 1913 convention of Association of Railroad Commissioners, pages 181-182.

cause certain investors who purchase such securities as an investment without knowing anything of the management of the corporation or the possibilities of the enterprise, to rely upon the state sanction of the issues. These are the investors who need protection, and who, I am apprehensive, will often be the victims of investments in ill-advised and mismanaged public service corporations whose securities have been authorized by state commissions. The business man who deals in such securities needs no protection. In my judgment, the responsibility of issuing corporate securities and applying the proceeds of same to corporate purposes should rest with the management of the corporation, subject, of course, to general statutory restrictions and limitations. . . .

As a result of the experience under the Wisconsin law, I have come to the conclusion that the English Companies Act is a much wiser measure for the regulation of the issues of corporate securities than any other laws or proposed measures that have come to my attention in this country. If I were to draft the law again, I should be guided by the fundamental principles of that Act.

Apparently the conviction that under special circumstances the issue of stock for a consideration admittedly of less value than par is allowable, has been growing in the minds of those active in the drafting of the more recent statutes, for there have been enacted a number of statutes permitting the issue of stock at a discount. In at least one instance the possible justification of overcapitalization is impliedly admitted. This is in the Texas law which provides that "no bonds or other indebtedness shall be increased, issued or executed, by any authority whatsoever, and secured by lien or mortgage on any railroad, or the franchises or property appurtenant or belonging thereto, over or above the reasonable value of said railroad property, provided, that in case of emergency, on conclusive proof shown by the company to the Railroad Commission that public interests or the preservation of the property demand it, *the said Commission may permit said bonds, together with the stock in the aggregate, to be executed to an amount not more than fifty per cent over the value of said property.*"

§ 32. Stock Issued at Discount

If stock issued at a discount is to be given a definition carrying with it an actual differentiation from "watered" stock, it may be said to consist of stock issued under lawful authority for an original consideration of fixed or admitted value less than par, but with all the rights and privileges of full-paid stock. It is to be distinguished from watered stock merely in degree and motive, in that the discount is supposed to be reasonable and the issue below par justifiable in view of the circumstances surrounding the issue. Watered stock is supposed to be in contravention of the law, while discounted stock is in accord with the law.

The public utility laws recently passed by some states have modified the rule as to issue of stock at less than par, so as to permit the issue of stock at a discount. The Michigan law imposes no limitations and leaves it to the orders of the Commission to determine the price of issue; the Ohio statute makes it incumbent upon the Commission to determine the terms of issue; the Massachusetts statute provides: "The decision of the Commission as to the amount of stock which is reasonably necessary for the purpose for which such stock is proposed to be issued shall be based upon the price at which such stock is to be issued and the Commission shall refuse to approve any particular issue of stock if, in its opinion, the price at which it is proposed to be issued is so low as to be inconsistent with the public interest."

Probably Massachusetts has experimented more than any other state with statutes regulating the price of issue, having tried out a number of expedients since as early as 1891. All issues at less than par were prohibited at first; then, after a few years the experiment of public auction sales was adopted from the English act for gas companies. Then came the anti-stock watering laws of 1894, fixing the price of issue to correspond with the market value, as ascertained by the Railroad Commission. For a number of years, during which generally pros-

perous conditions pushed market prices upward, this method worked well; under it the Boston and Maine Railroad Company was able to realize as high as \$190 a share. The 1903 panic and the subsequent depression proved the law to be unduly drastic and in 1908 the law was amended again to permit issue at a price, not less than par, to be determined by the stockholders and approved by the Commission. The present law as above quoted was an incident of the creation of a public service commission endowed with great regulative control over matters of finance.

A bill introduced into Congress (1913) to vest in the Interstate Commerce Commission control over the capitalization of interstate corporations (but which failed of passage) provided: "Any company which has been in continuous existence for more than two years may sell additional shares at a discount, if necessary to procure their sale; but no shares shall thus be sold at a discount without the previous express approval of the Interstate Commerce Commission as necessary and in the public interest."

The bill also provided: "It shall be lawful for such corporation to pay a commission to any person, if necessary as a consideration to his subscribing or agreeing to subscribe for any shares or procuring or agreeing to procure subscriptions." It is rather unusual to insert a provision such as the last into the statute, as ordinarily the right of a corporation to pay a commission for the sale of stock out of the proceeds of the sale is not questioned. In fact, that is the basis of the business of underwriting issues of securities.

It needs to be emphasized that unless the issue of stock at a discount is expressly permitted, the purchaser of shares at a discount will, as a matter of law, be liable for the amount of the discount to the corporation and its creditors.

There would be no object in marketing an original issue of stock at a discount, and the fact that it has been so marketed must be ascribed to the psychology of the investor. In the

case of bonds the discount earned by the purchaser operates to increase the actual return on the investment, for upon maturity the bond will be paid at its par value. But shares of stock do not mature; at no time during the life of the corporation, save for a brief instant in the earliest stages, will the value of the shares bear any relation to par value. The market value which the stockholder can hope to realize in normal conditions will be based upon the value of the property and its earning capacity—matters which will presumably bear no definite relation to the actual amount of the stockholders' original contribution.

There have been many instances where the financing of a corporate enterprise has been especially difficult, so much so that success of the project has necessitated an appeal to the trading instinct of the intending purchaser by an offer to sell stock to him below par. Consciously or unconsciously, the purchaser relies upon general acceptance of the par value as the measure of investment in the corporate capital, and therefore expects to be able to realize appreciation on his holdings through either one of two causes. Sometimes the stockholder hopes that he will be able to sell at a higher price than he paid, even though that price be less than the par, to another who, misled by the par value expressed, will think he is getting a bargain; other stockholders believe that the company will be permitted to earn on the basis of the par of stock rather than the capital invested, so that extra earnings will in time make up the difference and raise the value to par. It will sometimes be said that the issue at discount indicates the measure of risk which the purchaser is called upon to assume, and for which he demands extra compensation. The practice of stating dividends at a percentage of par, rather than a given amount per share, is in a way responsible for this idea; the truth of the matter, nevertheless, will still be as stated above.

A corporation seeking additional capital may find itself confronted with the fact that its outstanding stock has acquired

a definite market value, which necessarily limits the price at which any new issue of the same class of stock could be marketed. If the market value is below par, obviously the issue of new stock at par is out of the question. In such circumstances corporations have been compelled to borrow the needed additional capital, often at high rates of interest, while they would have preferred, and prudence would have dictated, that no increased burden of debt be assumed. The issue of stock at a discount here becomes a measure of conservative and prudent financing and should be allowed. The only objection is that since the new stock will be taken up on the books at par there will be created an apparent deficit,⁵ which the corporation may seek to make good by exacting a higher rate for its services—a thought which is disquieting to the peace of the public mind. It may, however, be but a very simple matter of justice that the corporation should be permitted to make good the deficit out of higher charges. If the initial issues had been made at par, the fact that market prices fell below par may very correctly indicate that the corporation was not collecting an adequate rate, and when its error is brought home to it, the corporation should be allowed to raise its rates and compel the public to make up the deficiency. Rate-making used to be a great experiment; even now it is anything but a science, and rates against the corporation's interest have been almost as frequent as those favoring it unduly. The effect of former abuses hinders ideal practice as yet.

§ 33. Stock Issued at Premium

There never has been any objection raised to the issue of shares at a premium, that is, for a consideration greater than its par value. Theoretically this is just as wrong as issue at a discount, but it has lacked the suspicion of being a dangerous expedient. Corporations which could command premiums

⁵ Assuming that the amount of the discount is not set up as a contra entry against the par value of stock but is charged directly to Profit and Loss account.

upon their shares have been considered fortunate, although that has not been an unusual situation by any means, as will be readily seen by reference to the balance sheets of some of the leading railroads. Usually, of course, the premiums are realized upon issues of additional stock, placed upon the market to raise new capital after the credit of the corporation has become established. The amount of the premium usually bears some relation to the dividends which have been paid by the company, the continuance of which is expected by the payer of the premium.

The generally accepted theory is that the premiums represent a payment by the purchasers of the stock for the privilege of acquiring a new or added interest. If this theory be given its logical effect, the premium will accrue to the favor of the existing stockholders, among whom it could be distributed as a special dividend, and there will be no reason for carrying the amount as a permanent reserve. The reason why a premium is paid is either that the value of the proportionate interest of the shares in the corporate assets exceeds their par value, or else that the assurance of earnings is such as to assign a high investment value to the shares. In the final analysis the last reason becomes merged in the first, for in most cases the value of the corporate assets as a whole is predicated upon earning power. Under these circumstances the premium is collected on the new shares to equalize the interests of the old and new stockholders. Let us assume that the old stockholders paid par, and thereafter put back enough earnings in the plant to give the stock a certain value above par; the new stockholders pay par also, and in addition an amount approximating the amount of earnings not taken out by the old stockholders. The two sets of stockholders are thus put upon an equal footing; they could then turn around and divide the corporate assets above the par of the total capital stock with absolute equity to both the old and the new stockholders.

§ 34. Accounting for Issues of Stock at Discount or Premium

Where capital stock is issued at a premium the uniform rule is that the amount of the premium shall be set upon the company's books under a proper designation, e.g., "Premiums Realized on Capital Stock," to remain there so long as the stock in connection with which it was realized remains outstanding. The account to which the premium is credited is customarily grouped with permanent reserve accounts, but will appear upon the balance sheet as a corporate responsibility of the same nature as the outstanding stock. The correctness of this method has generally been accepted without question, but if the reason for the collection of the premiums is that of equalizing the interests of the new stockholders with those of the old, should not the additional payment by the new stockholders be carried to the same account which registers the value-over-par interest of the old, to wit, the Corporate Surplus or Deficit account?

There is no actual loss suffered by a corporation issuing its stock at a discount; if the capital stock were taken upon the books only at the amount of its actual proceeds, no accounting for the discount would be necessary. But capital stock is taken up and will appear on the liabilities side of the balance sheet at its par value which, being greater than the proceeds which will be mingled with the assets, will produce an apparent loss. It is necessary that this amount be not confused with any others representing actual assets or actual losses incurred in operation. It will be set up as a deferred debit by being charged, under the rules of the Interstate Commerce Commission, to an account entitled "Unextinguished Discount on Capital Stock," in accordance with these instructions:

"If the nature of the balances in the Discount and Premiums accounts for all classes of capital stock sold is a debit balance, the amount should be stated in this account. This balance should be carried on the balance sheet until ex-

tinguished by premiums realized on subsequent sales of stock, by assessments levied on the stockholders, by appropriations of income or free surplus for the purpose, or by retiring the stock. When any stock is retired, the proper Discount and Premiums account should be adjusted by crediting to it an amount equal to the unextinguished discount on such stock."

The propriety of applying premiums on subsequent issues of stock to offset the discount on previous issues is open to question; if premiums can be thus written off, why could they not with equal propriety be written off by being credited directly to the Profit and Loss account?

Until recently where stock was issued at a discount, the practice has been to debit it to "Cost of Plant." Similarly for commissions. It is still permitted under official classifications to charge to capital accounts the commissions paid for the issue of stock. Commissions paid by English companies for the sale of their shares "or so much thereof as has not been written off, shall be stated in every balance sheet of the company until the whole amount thereof has been written off."

§ 35. Par Value in Relation to Actual Value

The very full discussion in the foregoing pages has sufficiently indicated the disparity which is bound to exist between the par value of the shares and the real value of the proportionate interest in the net corporate assets which they represent. If the value of all the property, claims, and interest owned by the corporation be listed and totaled, and from the total there be deducted the amount of debts and obligations owed, the remainder is the value of the proprietorship of the corporation, the value of the equity, the net corporate assets, or whatever one chooses to name it. That remainder is the capital stock, and divided by the number of shares, the quotient is the value of the shares. If there is no remainder, there is no equity, no proprietorship, and therefore no capital stock.

When the method is so simple, why has it been so hard for all interested parties to know the actual value of stock, so as to place no reliance upon a presumption that a value once fixed by the payment of a certain amount for a share continues to exist?

The first and greatest difficulty is that although it is easy to speak of the value of corporate assets, it is very difficult to substitute dollars and cents in place of the word "value." The attempts to determine and record actual values of the properties owned have caused considerable dispute heretofore; in many cases the attempt was an honest one, in other cases it was dishonest in purpose and execution. The condemnation justly leveled at the latter has unfortunately hit the former also, and in the recent regulation of accounting of public service corporations there has been total abandonment of the attempt to determine and record values so far as the bulk of the capital is concerned. The prescribed rules now are that *cost* shall be the figure recorded and maintained upon the books. The method above described thus becomes inapplicable, because the figure from which debts and obligations are deducted to arrive at proprietorship does not include the *value* of the properties owned; knowledge of facts other than those appearing upon the statement must be brought to bear upon a determination of real values of capital stock. These problems of accounting are more fully discussed in connection with the determination of surplus available for dividend payments (see Chapter VII).

The second difficulty has been purely an accounting one, an incident of it being the division of the figure of proprietorship between one account which has recorded the par value of stock and another or others which have recorded the excess or deficit of proprietorship from the par value of stock. The indefiniteness of accounting terms, to say nothing of the deliberate choice of misrepresentative ones, has been another incident. Considerable improvement may be expected in this

respect from the attempts to introduce uniformity of terms and practice by the promulgation of official accounting classifications. It is to be sincerely hoped, however, that those responsible for these official classifications will not forget that the determination of the real value of proprietorship was the primary purpose and continues to be an important purpose of all scientific accounting.

The third difficulty has been the lack of publicity. Stockholders and other interested parties have seldom been able to gain access to balance sheet and operating statements when it was necessary, and often such statements as were made public did not carry the stamp of authority. Recent legislation in this country has made a great deal of publicity possible and the results of this policy have proved most beneficial.

§ 36. Issue of Shares Without Par Value

There can be no question that the confusion between par value and real value has been the source of a great deal of mischief, and that on many occasions the confusion has been deliberately caused to facilitate the exploitation of unmeritorious schemes. There are many people, some of them quite sensible and prudent in other matters, who are eager to give good money for a certificate marked "Par Value \$100" if it is sold at \$90 or some other figure below par, and consider it a bargain without inquiring into the real value at all, which may be nil. The amount of worthless stock which has been sold by this very simple device cannot be estimated, and it still continues to run into large figures each year.

To remove the opportunity thus offered for exploitation, and to do away with the abuses which have crept into the present method, it has been suggested that certificates of stock should express no par value but represent merely a fractional interest in the corporate assets. The New York Public Service Commission at an early date approved the suggestion: "It may well be considered a matter worthy of grave reflection

whether in the case of at least all corporations hereafter organized a certificate of stock should have no par value, but should state only that the owner is entitled to a named proportional interest in the corporation. Every prospective purchaser would then be required to get a notion of the value of the property from a source other than the sums named on the certificate. The owner could not expect or demand returns upon a fictitious basis. The real would supersede the unreal in most investigations as to corporate values.”⁶

The Railroad Securities Commission, appointed by ex-President Taft to investigate the matter of federal supervision of railroad securities, also approved the suggestion: “We do not believe that the retention of the hundred dollar mark, or any other dollar mark, upon the face of the share of stock, is of essential importance. We are ready to recommend that the law should encourage the creation of companies whose shares have no par value and permit existing companies to change their stock into shares without par value whenever their convenience requires it. After such conversion any new shares could be sold at such prices as was deemed desirable by the Board of Directors As between the two alternatives of permitting the issue of stock below par or authorizing the creation of shares without par value, the latter seems to this Commission the preferable one. It is true that it will be less easy to introduce than the other because it is less in accord with existing business habits and usages, but it has the cardinal merit of accuracy. It makes no claim that the share thus issued is anything more than a participation certificate.”

In estimating the force of the Commission's recommendations it will be well to keep in mind the fact that it emphasizes the desirability of issuing shares without par value as an alternative of issuing at less than par stock having a par value. It does not require very much analysis to see that it cannot be

⁶ N. Y. C. & H. R. R. Co. and R. & E. Rapid Ry. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 294 (315).

such an alternative, for the considerations which will lead one to purchase stock having a par value and offered at a discount cannot apply to stock having no par value and where there can therefore be no discount.

§ 37. (1) New York Statute as to Shares Without Par Value

In 1912 New York amended its stock corporation law so as to permit the issue of stock without par value. The statute⁷ applies to corporations which are not moneyed corporations (i.e., banks, trust companies, etc.) and which are not subject to the jurisdiction of the Public Service Commissions. It provides that the certificate of incorporation may provide "for the issuance of the shares of stock of such corporation, *other than preferred stock having a preference as to principal*, without any nominal or par value. The certificate must set forth:

"The amount of capital with which the corporation will carry on business, which amount shall not be less than the amount of preferred stock (if any) authorized to be issued with a preference as to principal, and in addition thereto a sum equivalent to five dollars or some multiple of five dollars for every share authorized to be issued other than such preferred stock; but in no event shall the amount of such capital be less than five hundred dollars."

"Such corporation may issue and sell its authorized shares, from time to time, *for such consideration as may be prescribed in the certificate of incorporation*, or as from time to time may be fixed by the board of directors pursuant to authority conferred in such certificate, or if such certificate shall not so provide, then by the consent of the holders of two-thirds of each class of shares then outstanding given at a meeting called for that purpose in such manner as shall be prescribed by the by-laws. Any and all shares issued as permitted in this section shall be deemed fully paid and non-assessable and the holder

⁷ Stock Corporation Law, Section 19. Italics in quoted parts are not to be found in the original.

of such shares shall not be liable to the corporation or its creditors in respect thereof."

A well-known commentator⁸ on the New York statute states that while the method is a "radical innovation," it "is in accord with the views advocated by profound thinkers respecting a remedy arising from the evil of overcapitalization." Perhaps it is not as much of a radical innovation as is generally supposed, however; it is more of a reversion to the original conception of shares in the joint-stock type of associations of the sixteenth and seventeenth centuries, although their shares were not issued under the privilege of limited liability. Par value was introduced as a convenient method of indicating the division of capital stock into fractional shares, and the uses to which it has since been put have been directed very largely by the principle of limited liability and the theory to which that principle gave rise, viz., that capital stock was to be kept intact for the protection of creditors. The statute quoted itself implies that the par value had some necessary functions to perform, for stock preferred as to principal is still to carry a par value, and so far as the other stock is concerned, if the price of issue can be fixed by the certificate of incorporation as the statute specifies may be done, it becomes a debatable question whether after all there has been any radical departure from the method of issuing stock with a par value.

§ 38. (2) Characteristics Compared with Par Value of Shares

Removing the par value is not enough; standing by itself that change does not interpose any obstacle to the practices which have been the means of working overcapitalization heretofore. Take, for instance, the device of issuing shares in exchange for property or services accepted at an overvaluation; if the shares have a par value, the acceptor of the shares may reap a profit by reselling to those who will assume that

⁸ White on Corporations, 8th Ed., page 371.

the actual price paid for them upon issue equaled that paid for other shares of the same issue. If on the other hand the shares have no par value, the acceptor of the shares in exchange for property or services has precisely the same opportunity for profit by reselling to those who will likewise assume that those shares had been issued for consideration equaling that paid for other shares of that issue, since all shares of the one issue are required to be offered for sale upon like consideration.

Earlier in this chapter the reasons for carrying the par value of capital stock upon the books at par were discussed. Every one of those reasons applies with equal force and effect to the proceeds of the shares without par value, so that if confusion was caused by the former method, confusion will be caused by the latter as well. In place of the par value of capital stock now appearing on the liabilities side of the balance sheet, there will be substituted the total proceeds of the shares issued; this amount, increased or decreased by the corporate surplus or deficit, and divided by the number of shares, will give the apparent or book value of the shares at any particular date—precisely the same formula which is necessary in determining the value of shares carrying par value, and therefore subject to like limitations. If it were possible, because of the absence of par value, to omit making a separate entry relating to capital stock, a single item, e.g., "Proprietorship," might represent the total of the shareholders' interest, to wit, the original investment increased or decreased by profits or losses. It is very doubtful whether such a method would prove satisfactory. In connection with the accounting practice, the reader may turn back to the first chapter and note the practice of the joint-stock express companies whose shares have no par value but who, nevertheless, "for convenience report on the liabilities side of the balance sheet at a nominal par value the shares representing the beneficial interest of members."

To sum up the matter, the fact is that the omission of the par value is not a remedy sufficient in itself to cure the existing evils; to be effective, it must be accompanied by intelligent and constructive control over organization and administration, and an active governmental control of accounting, or the general acceptance of uniform accounting practices, supplemented by frequent reports prepared in a form readily reflecting the status of proprietorship interests. Given these conditions, however, it is undoubtedly true that the abuse of par value designations could also be prevented. The framers of the New York statute undoubtedly were of that opinion, to such an extent that corporations within the jurisdiction of the Public Service Commissions were excluded from the operation of the amendment permitting the issue of shares without par value.

There is no intention here to deprecate the activities of those who have advocated the omission of the par value, for even though that in itself will not accomplish the ends expected of it, still it will make easier the introduction of other remedies. The device of shares without par value must necessarily be experimented with for some time to come, and out of the experimentation there may develop an effective method for correcting the abuses of the past and reflecting in current records the actual value of shares of stock.

CHAPTER V

STOCKHOLDERS AND CORPORATE CONTROL

§ 39. Corporate Control

A share of capital stock in representing proprietary interest, also represents, as a necessary incident of proprietorship, a share in the actual present control and management of the corporation, to be exercised through the vote of the stockholder.

The power of control is an inherent attribute of stock, but stock possessing this power at the time of organization of the corporation may later part with it to gain some other distinct advantage. The advantage gained may be the assurance of a specified income in preference to the other stockholders, or the securing of additional capital for the enterprise, where those advancing the capital stipulate as a condition that they be permitted to exercise a certain degree of specific control or that certain others shall not exercise control.¹ Such modification of the power of control may be accomplished (a) by express contract between the stockholders, or between the corporation (acting pursuant to the authority of the stockholders) and the bondholders; or (b) by specific provisions of the certificate of incorporation; or (c) through by-laws adopted upon organization, in those cases where there is an implied contract made on behalf of the stockholders and running with the shares of stock.

The control of stockholders over the ordinary affairs of the corporation is an indirect one. The affairs of a corporation are administered by directors acting under the rules estab-

¹ See Chapter VI, § 56, and Chapter VIII, § 9a.

lished for the management of the corporation by the charter or by-laws. The active present control of a stockholder in the management of the corporation extends only to the formulation or amendment of those rules and to the election of directors. On matters affecting the corporate status, however, such as the increase of capital stock, mortgaging the corporate property, voluntary dissolution, etc., the stockholder exercises a direct control, since by statute these acts must be authorized by the stockholders themselves.

§ 40. Voting Rights

The voting rights vested in capital stock can be exercised only by the owner of the stock or someone acting for him. Except in the case of voting trusts, described in § 42, the stockholder may not alienate to another the voting rights attending his holdings; in other words, voting rights may not be vested in and be exercised by any one independently of the beneficial ownership of the shares of stock to which those rights attached. In New York, as well as in many other states, it is a statutory misdemeanor for any person entitled to vote at any meeting of the stockholders or bondholders to sell his vote, or to issue "a proxy to vote to any person for any sum of money or thing of value, except as expressly authorized by law."² This statute was to remedy certain abuses which are thus described by Sterne³ in referring to the investigation by the Hepburn Committee, appointed in 1879, of the abuses alleged to exist in the management of railroads in New York State:

"The attention of the Committee had been drawn to the evils connected with the proxy system, by which railways were captured by the mere purchase of voting power from persons, mainly bankers, in whose names large amounts of stock were registered, but which had been sold and distributed to

² Penal Law, Section 668.

³ Sterne on "Railroads in the United States."

their customers, and for prudent reasons were left standing in their names on the stock books of the companies. This situation gave to such persons a large voting power in the railway without a substantial interest or stake in the result of the vote. To persons who desired to capture the road, it was a strong temptation to purchase such voting power; and to persons who had no permanent interest in the road, it was a corresponding temptation to sell the power, the evil effects of the sale of which they were not personally called to bear."

The temptation has proved a universal one and its elimination by legislation has been difficult. The unlawful exercise of voting rights apart from the beneficial ownership of the shares is a punishable offense, the penalties in many European countries being far more severe than any prescribed in the United States. But while penal laws are clear in their terms, as far as they go, their enforcement is not easy because often the infringement seems of no particular moment and passes unnoticed. In other cases where the results would be such as to attract attention, the parties in interest are careful to choose a safer method.

The chief objection to alienating voting rights is that thereby those first entitled to the exercise of voting rights by virtue of proprietorship are afforded an opportunity for realizing profits which do not spring out of the corporate enterprise and its success, but rather out of the abuse and betrayal of the corporate interests by the proprietor who places a higher value upon a money or other consideration received from outside than he does upon the power to direct the business he is supposed to own. In preventing the alienation of voting rights, therefore, it is sought to hold the stockholders to a more conscientious exercise of their power for the single and undivided purpose of maintaining the corporate welfare. For the successful attainment of this object it is also necessary to prevent the shareholder from exercising his voting rights under the influence of a bribe. This would be as serious an

offense as the other, and is punishable as are all offenses of bribery. In other countries where the regulation of these matters is more strict, the penal laws specifically provide for fine or imprisonment or both of the shareholder or duly appointed proxy who agrees to vote in some particular way, or not to vote at all, in consideration of some special advantage to accrue to him. To safeguard still further the corporate interests from being made subservient to the private interests of the shareholders or of some of them, the statutes of these other countries prohibit a shareholder from voting in opposition to the obligations which he may have incurred toward the corporation, or on a resolution which discharges or relieves him from the performance of a duty, or one relating to a transaction or litigation between the company and himself.

§ 41. Proxies

The word "proxy" is a contraction of the old word "procuracy"—"procuracion"—a term still used in connection with negotiable instruments. It has a dual meaning, referring both to the person who is authorized to act for another and to the written instrument which gives him his authority.

The right of a stockholder to vote by proxy is not an absolute one but is given him through provisions in the charter or by the statutes of the state in which the corporation is organized. The statutes of practically all states give him this right.

The proxy system has been subject to many abuses and misuses, such as those already referred to, and in spite of much remedial legislation, many evils still exist and will continue to exist so long as stockholders consider their holdings simply as investments, involving no obligation of active interest in the affairs of the corporation, which they are content to leave to a few men to manage as they see fit, provided the apparent integrity of their investment is not impaired. Because of this indifference, the minority often control corporation action.

§ 42. Voting Trusts

One special form of arrangement under which voting rights may be absolutely alienated from the ownership of the stock is permitted under the laws of many states in what is known as a voting trust agreement.

It is sometimes desirable that the voting power of a number of stockholders should be unified, or "pooled," in the hands of a few persons for a definite time. The stockholders desiring to participate in the arrangement designate certain persons as "voting trustees" to exercise their combined voting powers; then, under a written agreement, they surrender their stock certificates which are transferred to the names of the trustees on the stock book. Each stockholder in exchange for his certificate of stock receives from the trustees a "voting trust certificate" corresponding somewhat to an ordinary bank certificate of deposit and representing an aggregate amount equal to the stock deposited. These certificates are negotiable and are transferable on special books kept for the purpose by the voting trustees. The effect of this exchange of certificates is temporarily to divest the stockholder of the legal title to his shares, which becomes vested in the voting trustees, but to retain in himself the beneficial interest. Dividends declared during the voting trust accrue in favor of the stockholders.

The duration of a voting trust is limited by statute in New York to five years. A copy of the agreement must be filed in the office of the corporation and kept open for the inspection of stockholders. The entry upon the stock book transferring the stock to the names of the trustees must also indicate that the transfer is by virtue of a voting trust agreement.

An agreement such as this comes within the laws governing contracts and will be invalid if its purpose is against public policy, contrary to law, unconscionable in its attempt to advance the interests of the parties thereto at the expense of the minority stockholders, to perpetrate fraud, or to effect an illegal combination.

An arrangement of this kind must not be confused with that under which stockholders living at a distance from each other or from the corporate office, or unable to give the necessary personal attention, for the purpose of concerted action give to a committee of their number the right to vote their stock, which they place in a designated depository. This plan is very often resorted to in the case of reorganization committees; it is an extension of the proxy system and any stockholder may retire from it at his option. It differs from the voting trust in that in the latter the voting rights of stockholders are absolutely alienated and may be exercised by the trustees as they see fit.

§ 43. Majority Control

It is a general rule applicable to all associations, whether incorporated or not, that a majority of shareholders or members may bind the whole association, while acting in the manner and for the purposes originally agreed upon; hence the control of a corporation is lodged in the hands of the holders of a majority of the outstanding capital stock, irrespective of the amount authorized. As a matter of fact, in our large corporations where the number of stockholders runs into the thousands and tens of thousands, less than a numerical majority is sufficient to exercise control. It may be stated as a general rule that the greater the number of stockholders, the smaller is the proportion of shares necessary to exercise corporate control. The "uncontrolling" shareholders, although owning a majority of the stock, have ordinarily no way of getting together for concerted action, and very often know but little, if anything at all, of the corporate affairs. Only a small proportion of them read the reports sent them, if any are published, while the number of those who read and understand these reports is still smaller. It is this indifference which permits one individual holding a minority, or a number of individuals holding shares totaling to a small part of the aggre-

gate but who work in concert, to become controlling and to maintain their control as effectually as if they owned a majority of the shares.

In the decree of dissolution of the Union Pacific, the Supreme Court of the United States, referring to the ownership by the Union Pacific of only 46 per cent of the Southern Pacific stock, pointed out that the ownership of less than a legal majority could carry absolute control. "It may be true that in small corporations the holding of less than a majority of the stock would not amount to control, but the testimony in this case is ample to show that, distributed as the stock is among many stockholders, united ownership of 46 per cent is ample to control the operations of the corporation." The "uncontrolling" shareholders, when they became stockholders, had probably no desire to take an active part in corporate affairs, and so long as the integrity of their investment is maintained they trouble themselves but little as to matters of administration or policy; too often they are content to give their proxies, by filling in blanks sent them for that purpose, to agents of the controlling shareholders without any question arising in their minds as to the fitness of the proxy seeker to continue in control of the property.

At meetings of stockholders for the election of directors and the transaction of ordinary routine business, the statute does not require any specified proportion of the capital stock to be represented. The by-laws will define a quorum. The vote of a majority of the stock represented is sufficient to elect or to adopt routine resolutions. In special matters, e.g., the increase of capital stock, amendment of charter, mortgaging of property, consolidation with another corporation, etc., the statute requires unanimous action of stockholders representing a majority of the total outstanding shares of capital stock. Similar requirements may be imposed by the conditions of preferment of one class of stock, or by agreement between the stockholders and bondholders.

§ 44. Special Responsibilities of Majority Stockholders

A majority or controlling stockholder is subject to certain responsibilities towards the minority stockholders in dealing with the corporate property. It has been repeatedly held by our courts that a majority stockholder stands in a peculiar position as regards the minority holders; that he becomes a trustee for them.

"The holder of the majority of the stock of a corporation has the power, by the election of biddable directors and by the vote of his stock, to do everything that the corporation can do. His power to control and direct the action of the corporation places him in its shoes, and constitutes him the actual, if not the technical, trustee for the holders of the minority of the stock. He draws to himself and uses all the powers of the corporation. In effect he holds an irrevocable power of attorney from the minority stockholders to manage and to sell the property of the corporation, for himself and for them. Times, places, and notices of meetings of the directors and of meetings of the stockholders become of secondary importance, because the presence, the vote, and the protest of holders of the minority of the stock are unavailing against the will of the holder of the majority. They can act and contract regarding the corporate property, they can preserve and protect their interests in it, only through him and through the courts.

"The devolution of unlimited power imposes on a single holder of a majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock, who can act only through him; the duty to exercise good faith, care, and diligence to make the property of the corporation produce the largest possible amount, to protect the interests of the holders of the minority of the stock, and to secure and pay over to them their just proportion of the income and of the proceeds of the corporate property. Any sale of the property of the corporation by him to himself for less than he could obtain for it from another, or any other

act in his interest to the detriment of the holders of the minority of the stock, becomes a breach of duty and of trust, renders the sale or act voidable at the election of the minority stockholders, and invokes plenary relief from a court of chancery.”⁴

Not only does this relationship exist in the case of an individual majority stockholder, but also of a group of stockholders and of a corporation owning a majority of stock:

“The law requires of the majority of the stockholders the utmost good faith in their control and management of the corporation as regards the minority, and in this respect the majority stand in much the same attitude towards the minority that the directors sustain towards all the stockholders. Hence, where the majority are interested in another corporation, and the two corporations have contracts between them, it is fraudulent for that majority to manage the affairs of the first corporation for the benefit of the second. A court of equity will intervene and protect the minority upon an application by the latter.”⁵

“Where . . . a majority of the stock is owned by a corporation or a combination of individuals, and it assumes the control of another company’s business and affairs through its control of the officers and directors of the corporation, it would seem that for all practical purposes, it becomes the corporation of which it holds a majority of stock, and assumes the same trust relation towards the minority stockholders that a corporation itself usually bears to its stockholders, and therefore, under such circumstances, the rule stated . . . applies to majority stockholders who control the affairs of the company, as well as to its directors and officers.”⁶

§ 45. Minority Representation

There are those who, through the system of lodging control of corporate affairs in the hands of a bare majority, have

⁴ *Wheeler v. Abilene Natl. Bank Bldg. Co.*, 159 Fed. Rep. 391 (393-394).

⁵ 2 *Cook on Corporations*, 7th Ed., § 66a.

⁶ *Farmers’ Loan & Trust Co. v. New York & Northern R. Co.*, 150 N. Y. 410 (430).

come into power and have been able to perpetuate themselves in power through ownership of that controlling interest or their knowledge of where the votes are, together with facilities for controlling those votes. These have not always maintained the integrity of stockholders' investments but have allowed such values to be impaired in order that their own personal fortunes might be promoted. Majority stockholders have not always recognized their responsibilities to the minority stockholders; they have used their power of control as a means of advancing their own private interests at the expense of other stockholders' investments. Against the acts of such persons the law has afforded scant relief, for they are careful to adhere strictly to the technicalities of the corporate form, and have otherwise adopted methods which hide successfully the indications of wrong-doing.

To protect stockholders from the abuse of power by the directorate, it has been sought to devise a method of limiting the electing power of the majority holders while correspondingly increasing that of the minority holders.

One method devised has been that of inserting in the charter a provision that no stockholder, either in his own right or by proxy, shall cast more than a certain proportion, for instance, one-fourth, of all the votes cast at an election of directors, or vote for more than two-thirds of the directors to be elected.

A more general method, and one provided for in the statutes of many states, is that of cumulative voting. At an election of directors a stockholder may vote his holdings for each candidate, and on each vote taken the ratio of the number of votes cast by him to the total number remains the same. Under the cumulative plan he is permitted to cast as many votes as will equal the number of his shares of stock multiplied by the number of directors to be elected; he may cast the total number in favor of one candidate or divide among two or more, hence the ratio of the number of votes cast by

him to the total number will be greater in the votes for some directors than for others, depending on the extent to which the minority holder has sought to focus his strength on the election of one director, of two directors, etc. Thus, if there are ten directors to be elected, the holder of twenty-five shares, instead of being obliged to cast not more than twenty-five votes for each candidate, may cast the total two hundred and fifty votes in favor of one candidate, or may divide that number of votes among two or more candidates as may be necessary to secure representation on the directorate.

§ 46. Qualifications of Stockholders

As a general rule, all natural persons not placed under some legally established disability may become stockholders, and share in the advantages, exercise the rights, and be subjected to the duties created by that relationship.

Corporations may become stockholders in other corporations provided that the acquiring and holding of shares of stock is one of the powers granted them by their charter. While a corporation may become a stockholder, it seems that under no circumstances can it become an incorporator; for instance, where the certificate of incorporation is required to name the incorporators and state the number of shares subscribed for by each of them, none of those names may be that of another corporation. This is logical; a corporation is a legal entity which may be created only through the agency of natural persons.

While corporations may, in general, become stockholders, public service corporations are subjected to certain restrictions. In New York, for instance, the Public Service Commissions Law forbids any stock corporation (except railroad, street railroad, electrical, gas, telephone or telegraph corporations) to acquire or hold more than 10 per cent of the capital stock of a railroad, street railroad, electrical, gas, telephone or telegraph company. Corporations which upon the enactment of

the statute already held a majority of the stock of any corporation can thereafter, with the consent of the Commission, acquire the remainder of the outstanding capital stock of that corporation. Railroad corporations may not, without the consent of the Commission, acquire shares of stock of other railroad or street railroad corporations; street railroad corporations, of railroad or other street railroad or electrical corporations; electrical corporations, of street railroad corporations or of other electrical corporations; gas corporations, of other gas corporations. The corporations specified are also prohibited from transferring on their books or recognizing transfers of stock violating these prohibitions, as already noted.

§ 47. Stock of Corporation Held by Itself

It is generally understood that a corporation cannot be its own stockholder; it cannot issue its own stock to itself. The law with its many fictions has not accepted any device which will support that situation. Under some circumstances, however, it may acquire shares of its stock which have once been legally issued, but shares thus reacquired cannot be considered as alive but lie dormant, not sharing corporation profits or control.

Statutes generally provide that a corporation may repurchase its own stock, but only out of surplus profits, and the New York statute permits it to accept "shares of its capital stock in complete or partial settlement of a debt owing to the corporation, which by the Board of Directors shall be deemed to be bad or doubtful." The prohibition against the acquisition of capital stock, except out of surplus profits, is intended to conserve creditors' rights by preventing any attempt to distribute capital among the stockholders, thereby lessening the corporation's ability to meet its debts. Of course, it may also acquire its own stock by gift—the usual method where the acquisition is incident to a plan of reducing the capital stock.

CHAPTER VI

CLASSIFICATION OF CAPITAL STOCK

§ 48. Authority for Classification

There is no principle of law forbidding the members of any association to define and fix as between themselves the nature and extent of their individual rights or obligations. In the absence of any agreement the law will, where it finds a common undertaking, presume the equal share of responsibility and benefit of each one associated therewith. Thus, partners are jointly and severally liable on partnership debts and share alike in the profits or losses, but they may by agreement between themselves fix unequal or unlike shares in profits and responsibility for debts, subject, of course, to the imperative condition that rights of third parties are not prejudiced thereby.

The members of a stock corporation occupy a position not different from that of the members of any other association, in this respect. They also may agree among themselves as to the nature and extent of their interests so as to create unequal or unlike rights. Any inequality in the measure of interest is primarily taken care of by the device of shares of stock, each representing an equal proportion of interest, so that the number of shares held by each stockholder will definitely fix the proportion of his interest. In this respect the shares are all alike. It is the conferring of special privileges or preferences upon certain shares that creates inequality or unlikeness of rights, and divides the stock into classes such as preferred and common. Preferences most commonly conferred are in respect of priority of claims in the distribution of assets upon dissolution of the corporation, or in the distribution of earn-

ings, or in respect to immediate control of the corporate affairs. The usual preference is in regard to dividends.

Prior to issue, classification of capital stock may be effected by proper provisions inserted in the certificate of incorporation; subsequent classification or reclassification may be effected likewise by amending the certificate; all shares of stock issued will, of course, be identified specifically as belonging to one or another class. It has been held also that classification may be effected independently of provisions in the certificate, by rules inserted in the by-laws at the time of organizing the corporation; the rights of the existing shareholders will be modified accordingly and every subsequent shareholder will be charged with notice of the preference and held to its terms.

If the authorization of a public service commission is necessary to the issue of stock in the first instance, like authorization is undoubtedly necessary to any subsequent classification or reclassification of the stock. There seem to have been no definite rulings upon this point, however, and instances are to be found where reclassification was carried out without application to the commission. Of course, if the stock had been approved by the commission in the first instance, subsequent classification without its authority would be altogether improper.

§ 49. Common Stock

In the absence of classification all of the capital stock is common capital stock, since there is no other class of stock whose claims in the distribution of assets are either superior or subordinate to it.

It is possible that there may be outstanding at some time but one class of stock which will be described as "preferred"; this can happen only where the authorized capital stock has been classified and the preferred portion alone has been issued, the common stock being temporarily withheld.

It is hardly necessary to mention that the rights of all stockholders of common stock are equal in all respects, and if there is no classification every stockholder is possessed of all the rights usually pertaining to a stockholder. Apparent exceptions to this rule may be found, however; for instance, the Bethlehem Steel Corporation has outstanding common "A" and common "B" (non-voting) stocks.

§ 50. Preferred Stock

Where one class of stock is endowed with claims superior to another in respect of participation in profits, in the distribution of assets, or in quality of control, it is usually called preferred stock, the stock over which it is thus preferred being designated either as common stock or a subordinate issue of preferred, for the classification of a stock issue may be into more than two classes, each varying from the others in the nature and extent of preferences. Thus, the class most highly preferred will be first preferred; then, in descending order of preference, will follow second preferred, third preferred, etc., down to common. There are comparatively few cases on record where more than two classes of preferred stock have been issued, because it becomes very difficult to work out a gradation of preferences to such an extent. The high degree of preference required to be conferred on the first preferred where there is outstanding a third or less preferred issue would approximate it so closely to a bond as to overlap the rights of creditors; moreover, the extent of preferred rights which would necessarily be exercised by stock so highly preferred would destroy the value of issues lower down the scale. Ordinarily the issue of a modified form of bonds is preferable.

§ 51. Preferment as to Assets

In the absence of express stipulation, both preferred and common stock share equally in the distribution of the assets upon dissolution. It may be agreed, however, and very often

is, that the preferred stock will share up to par, or to par plus accrued dividends (usual in the case of cumulative preferred stock) before the common may participate at all. Stock so preferred is said to be preferred as to assets, as to principal, or as to capital. The statute may require, as in New Jersey, that all stock designated "preferred" shall always be preferred as to assets.

Stock preferred as to assets, after it has received par in the distribution of assets will not participate further until the common or other junior issues also receive par. If any surplus remains, all classes will ordinarily share equally in its distribution, although the terms of preference may expressly fix the par value of the stock as the limit of the right of its stockholders to participate in the distribution.

It has already been stated (§ 37) that the New York statute permitting the issue of shares without a nominal or par value expressly excludes shares of stock preferred as to principal.

§ 52. Lien of Preferred Stock

The claim of preference in the distribution of assets can be exercised only during liquidation of the corporation and then it attaches only to the residue after the claims of all creditors have been met in full. Stockholders preferred as to assets cannot exercise any special lien or claim on the property of the corporation not in process of liquidation. There have been attempts to confer upon preferred stock the right to impose a specific lien on the property of the corporation, but instances of this nature are rare in this country and mark the borderland between the status of a stockholder and that of a creditor.

A stockholder is a partner in an enterprise, not a creditor; his beneficial interest in the corporate business, evidenced by his ownership of shares of its capital stock, is the interest of a partner subject to all the risk (save the full measure of liabil-

ity) attaching to proprietorship and partnership. Although the claims of certain stockholders may be preferred over others as to earnings and assets, they cannot become the claims of creditors.

There have been statutes in some states which have been thought to confer upon certain classes of preferred stockholders at least some of the rights usually pertaining only to creditors. In order that the relationship of debtor and creditor may exist, there must be a valid and absolute obligation on the part of the corporation to pay a stipulated sum at a known or determinable future date, or upon the happening of a contingency. The debt may or may not carry with it the duty to pay interest at a fixed rate, and at specified intervals. Even if there is no prearranged date for the repayment of the principal, if the interest provisions are such that upon default the one entitled thereto may sue as upon a matured obligation, there is sufficient definiteness in the terms of repayment to create the relationship of a creditor.

A stockholder is not a creditor, and it is incorrect to describe as a share of stock any certificate the owner of which will be deemed to be a creditor by reason of that ownership. Certificates which have that effect evidence a debt of the corporation and should be described accordingly.

A Maryland statute, for instance, authorizes the issue of so-called preferred stock, the holders of which have priority over subsequent mortgagees. An Ohio statute authorizes the issue of preferred stock redeemable by the company at a fixed time, with guaranteed dividends, the payment of the principal or dividends being secured by bond and mortgage, the holders having no right to vote and being declared by statute exempt from the liability to creditors which by the state's constitution attaches to all members of a corporation; these securities are clearly in the nature of funded debt securities and the courts have rightly held that the holders thereof are creditors and not stockholders.

§ 53. Preferment in Dividends

Preference in the distribution of dividends is the most usual basis of classification. In the limitation and definition of the conditions under which and the extent to which this preference may be exercised there is a very great variety of methods, dividing preferred stocks generally into four classes, to wit: participating and non-participating, cumulative and non-cumulative.

Where the inherent nature of capital stock has not been modified by statute, and the securities really represent shares in proprietorship, there can be no valid provisions binding the corporation itself, absolutely and irrespective of earnings, to pay dividends at a stipulated rate.

§ 54. (1) Participating and Non-participating

Where shares of stock are preferred as to dividends, a rate per cent is stipulated which must be paid before the subordinate classes may share in the profits. If the preferred stock is limited to this stipulated rate it is non-participating; that is, dividends at the stipulated rate having been paid out of the profits for a certain period, the preferred stock has no further claim upon the profits for that period. If the preferred stock is not limited to the stipulated rate but may share further in the distribution of dividends, it is participating.

The terms according to which participating preferred stocks may share in the distribution of profits beyond the stipulated rate, vary greatly. For instance, the preferred may be entitled to 6 per cent or some other rate in preference to the common, then the common will be entitled to a like or possibly a different rate (say, 5 per cent); if there are any remaining profits available for distribution after both classes have shared, the preferred will be entitled to 3 per cent more, then the common may take 3 per cent more, or both classes may share equally beyond the first rate stipulated on the preferred. Or there may be other conditions; for instance, that

for a period of five years the rate shall be 5 per cent, thereafter 6 per cent; or that the increase in the rate shall be contingent, to be fixed at 5 per cent, for example, increasing to 6 per cent whenever the common stock is itself placed on a 6 per cent basis, or in another instance, after the common stock shall have for two years received dividends at the rate of 5 per cent, etc.

The stipulated rates of dividends on preferred stock range from 4 to 8 per cent. A few states have prescribed maximum rates of dividends; Wisconsin, for instance, limits the preference on stocks of public service corporations to 8 per cent.

In applying to the New York Public Service Commission (Second District) for authority to issue \$250,000 of 8 per cent cumulative preferred stock, the Newburgh Light, Heat and Power Company set forth that it could not under the then prevailing market conditions (1907) borrow money or sell its stock under a dividend rate of less than 8 per cent. The Commission denied the application, saying that even if the contentions were accepted as entirely meritorious, "the order applied for should not, in our opinion, be entered. An issue of \$250,000 8 per cent cumulative preferred stock would create a permanent annual charge of \$20,000 upon the property, and, in our judgment, allowance of a permanent fixed charge of this character to meet temporary exigencies of the money market is not justified. The distinction between a continuing capital burden of that description and an issue of bonds or notes for a short term bearing a fair rate of interest, even if sold at a moderate discount, is obvious. Favorable action upon this petition would constitute a precedent which, if followed in other cases, might operate disastrously to minority stockholders, and also work hardship upon affected communities through the continuous necessity for service rates or charges sufficiently high to meet such permanent obligations."¹ Upon a subsequent application the issue of 8 per cent

¹ Matter of Newburgh Lt., Ht. and Pr. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 7.

debenture bonds to be issued at par, and convertible after two years for common capital stock, was authorized.

§ 55. (2) Cumulative and Non-cumulative

Both participating and non-participating preferred stocks are either cumulative or non-cumulative. Preferred stock is said to be cumulative when the contract provides that dividends not paid when due, or the deficiency remaining after the payment of a dividend at less than the fixed rate, shall remain an obligation, as far as the common stock is concerned, until paid. Past-due dividends on cumulative preferred stock must be paid before the common stockholders may receive any dividend. Non-cumulative preferred stock may have its dividend passed without there remaining any obligation to pay in the future.

A cumulative dividend deficiency remaining unpaid pending the accumulation of sufficient profits, or for some other reason, does not earn interest. But should the deficiency arise from the wilful diversion to subordinate classes of stock of surplus profits properly available for the payment of dividends, interest probably could be recovered as part of the damages for the fraudulent or wrongful act.

Although a cumulative dividend deficiency becomes a charge against the profits of succeeding years, dividends paid in one period in excess of the stipulated rate cannot be credited against the deficiency of a future period.

The issue of cumulative preferred stocks may detract from the value of subordinate issues, since it lessens the prospect or limits the amount of dividends apportionable to them. A number of "passed" dividends may become such an enormous charge upon the future earnings of the company as to render the common stock practically worthless. A good illustration of this is found in 7 per cent cumulative preferred stock issue of the Rutland Railroad Company, the accumulated dividends on which are said to aggregate over 235 per cent; obviously, in the absence of a financial rearrangement, the common stock

of the company (of which there is a very small amount outstanding, i.e., \$199,000 against \$9,000,000 of preferred) has no chance of earning dividends although the stock continues to have some value and its voting control remains undiminished. There is danger in such a situation, for the value of the stock may shrink so much that it may easily accumulate in the hands of one or a group of persons who may be more interested in manipulating the corporate affairs for a speculative increase in value of their holdings than in the permanent improvement of the corporate finances.

On the other hand, the "non-cumulative" feature may allow the common stockholders, through their officers, to delay the payment of dividends on preferred until a surplus has been acquired by the company sufficient in amount to enable the common stockholders to participate also in its distribution; or, the representatives of the common stock may continue to apply the profits to improvements until the industry shall become so highly profitable through added capital that the regular return to the common stock may far exceed that fixed for the preferred.

§ 56. Preferment in Control

A right to share in control attaches to every share of stock representing proprietorship. The measure of the right and the conditions under which it may be exercised can be made a matter of agreement; if some shares surrender or delimit their own rights there will be created a preferment in certain other shares. It would be an extraordinary situation to find one class of capital stock preferred over another solely in the matter of voting rights; inequality in the relative rights of shares in this respect is ordinarily to be found when the stock has been classified on some other basis causing the issue of preferred and common shares, and the superior voting rights may be vested either in the preferred stock or in the common stock.

Preferment in voting rights is not a necessary incident of preferred stocks; it cannot even be said to be a common incident. Such preferment is granted where the then existing stockholders cannot secure the added capital necessary for the enterprise without relinquishing in favor of the preferred stockholders such a portion of their controlling power in general or in specific matters as will enable the preferred stockholders adequately to protect their investment. It must be remembered that the classification of stock means the introduction of divergent interests participating in control, each exercising its voting power to protect or strengthen its own investment. For example, if in addition to the common there is outstanding preferred cumulative, non-participating, 7 per cent stock, which earns its dividends regularly while the common stock is able to earn only 3 per cent, the preferred stockholders will seek to conserve their interests by maintaining the operating status, while the common stockholders will be anxious to extend operations even at the cost of greater hazard, if there is the least probability of increased returns upon their holdings. Of course, under a classification such as that cited, the interests of the two might sometimes coincide; for instance, if neither class were earning the expected dividends. If voting rights of preferred and common stock are equal, and there are a much larger number of shares of common than preferred stock outstanding, the common stockholders might become firmly entrenched in control. In such a case preferred stockholders will demand actual preferment in voting rights so as to protect their own position.

Preference in voting rights may be general, specific, or contingent. General preference exists where preferred stock is actually given a greater voting right per share than the common, e.g., one vote for each share of preferred as against one vote for two shares of common. Such general preference may have a contingent limitation; for instance, control may be vested in the preferred stock until such time as the preferred

shall have received 6 per cent per annum for three consecutive years, and thereafter the rights of the preferred and common shares will be equal.

Specific preference vests in the preferred stock greater voting power than is possessed by the common, to be exercised only in respect of certain specified corporate acts. An instance of a very broad grant of such preference, almost amounting to general preference, is that vesting in preferred stock the right to elect a majority of the board of directors. Most cases of specific preference really amount to a veto power over the action of the common stockholders, a very usual condition being the limitation upon the power of the common stockholders to authorize an increase in the amount of preferred stock or an increase in bonds over a certain amount. It may be that two-thirds of the outstanding preferred stock will be required to consent to any increase in preferred stock or any new mortgage, while of common stock only the majority vote of the amounts represented at a meeting may be necessary.

Stock which cannot exercise superior voting power until a certain event occurs or a special situation develops, is subject to contingent preference. An example of contingent specific preferment is the right of preferred stockholders to elect a majority of the directors should the company fail for two successive years to earn and pay dividends at the stipulated rate.

Where greater voting power is lodged in the preferred stock it is because a like amount of power has been given up by the common stockholders in consideration of the assurance of capital. The contrary situation also arises, however, and greater voting power may be vested in the common stock at the expense of the preferred, the waiver by the latter being in consideration of an assured specific income. There seems to be nothing in the court decisions or in text-books to indicate that this waiver may not be an absolute one, but the writer's

opinion is that it cannot be made so, and that upon certain contingencies, such as apparent mismanagement jeopardizing the rights or diverting the profits, equity will restore to the preferred stockholders so much of the power which they had surrendered as may be necessary to safeguard their interests. In many cases this waiver is not absolute in its terms but relinquishes rights in some matters and reserves them in others. For instance, the consent of stock otherwise having no general voting rights may be necessary to the issuing of any new mortgage, or to create any other preference, or to dissolve the corporation.

If by its terms the waiver is conditional upon the performance of certain acts, such as the regular payment of dividends, failure to perform those acts will return control to the preferred stockholders.

Preferred stock without voting power is sometimes issued where control is sought to be centered in one group. For such a purpose this device may be preferable to the issue of bonds, either because of readier sale, or because it eliminates the possibility of the controlling group being ousted through foreclosure of mortgage.

§ 57. Convertible Preferred Stock

Sometimes preferred stock of one class is made convertible at the option of the holder into common or other subordinate issue of stock or into bonds. This privilege of conversion may be exercised immediately, or after a certain date, or within a certain period, and the conversion may be effected at par of the securities for which converted or in other proportions.

A right of conversion into common stock is most valuable if it accompanies non-participating stocks carrying a low rate of dividends (say, 4 per cent); should the profits of the company be sufficient to pay a higher rate (say, 8 per cent) regularly on the common stock, the preferred shares can with ad-

vantage be converted into common. Note, for instance, that the common stock of the Union Pacific Railroad Company ever since the spring of 1904 has sold at higher prices than the 4 per cent non-participating preferred stock; the highest quotation for the preferred has been 118, while the common once reached 219. The right may also become valuable in the case of preferred stock with limited voting power. If it should appear that the attitude of those in control is inimical to the interests of the preferred holders, the latter could convert their holdings into voting shares and themselves assume control, provided their aggregate holdings were sufficient.

The use of conversion privileges is better known in connection with bonds and is discussed in that connection (§ 120). Bonds convertible into stock have been issued frequently; instances of stocks convertible into bonds are also to be found, however. The 4 per cent non-cumulative second preferred stock of the Reading Company, which after dividends at 4 per cent have been paid for two consecutive years may be converted at the option of the company at par, one-half into first preferred and one-half into common, is an interesting example of convertible stock. The conversion being at the option of the company, this stock is more correctly described as redeemable, falling within the class referred to below.

§ 58. Redeemable Preferred Stock

Some preferred stocks are made callable, or redeemable, at the option of the corporation to be exercised under stipulated conditions as to manner and time. Considerations applying to the redemption of preferred stock are very similar to those which apply to the redemption of bonds (see Chapter XI), and similarly the option may be exercised at any time, or after a certain date, or within a certain period; often, also, a premium is paid upon redemption. The option of redemption has very frequently been reserved by railroad corporations issuing preferred stocks.

A famous instance of the use of the right of redemption was that incidental to the contest in 1901 between the Harriman and the Hill interests for the control of the Northern Pacific Railroad. At the height of the contest, the Harriman-Kuhn, Loeb Syndicate owned \$37,000,000 of the outstanding \$80,000,000 common stock, and \$42,000,000 of the \$75,000,000 preferred stock—a total of \$79,000,000 which represented a clear majority of *all* the outstanding stock. The Hill interests acquired \$42,000,000 of the common stock, representing a majority of \$2,000,000 of the *common stock only*. The preferred possessed the same voting power as the common, but was subject to redemption at par up to January, 1912. The Hill interests controlling a majority of the common stock announced their intention of exercising the option and accordingly redeemed all the preferred, thereby acquiring absolute control. The Harriman group succeeded in getting only one representative on the board of directors.

§ 59. Special Classes of Stocks

There are a great number of special classes of capital stock which take their names from special attributes attaching to them. It is unnecessary to note all of these; the citation of a few of the more important ones will be sufficient.

Interest-bearing Stock. Reference to this class of stock can be found in some of the older discussions of railroad finance; it is now practically obsolete. Interest-bearing stock was issued in lieu of preferred stock and it consisted of the ordinary common stock issued under an agreement that the corporation would pay interest thereon during the period when its railroad remained under construction, for instance, or until it was placed in operation. Although the promise was that of paying "interest," it was construed by the courts to be a promise to pay out of profits, for otherwise the agreement would fail by reason of being against public policy. The title "interest-bearing" is therefore inaccurate; the return prom-

ised is really a cumulative dividend, the accumulation to cease upon the happening of the specified and contemplated event, and payment of the amount to become due in whole or in part as the company became possessed of sufficient accumulated profits to pay part or the whole. The accumulated amount must be discharged in full before dividends can be declared upon other classes of stock. The sole purpose of the expedient was that of offering an incentive to investors in order to attract capital during a period of construction when in the nature of things no profits could be earned. Authority for the issue of capital stock of this class is still to be found upon the Massachusetts statute books.

Special Stock. The issue of special stock, so called, is provided for by the Massachusetts laws. It is described as "a peculiar kind of stock, distinctly provided for by statute,"² and sharply distinguished from preferred stock. "Its characteristics are that it is limited in amount to two-fifths of the actual capital; it is subject to redemption by the corporation at par after a fixed time, to be expressed in the certificates; the corporation is bound to pay a fixed sum as dividends; the holders of it are in no event liable for the debts of the corporation beyond their stock, and the issue of special stock makes all the general stockholders liable for all the debts and contracts of the corporation until the special stock is fully redeemed."

Founders' Shares. Shares of this class were never received with favor in this country and probably have not been used for many years. Even in England, where it originated, stock of this nature appears now to be but little used. Its function was that of securing to the promoters control of the business and the largest measure of profits if the enterprise became successful. The common or preferred stocks were first to share in the available profits up to, say, 7 to 9 and 10 per cent, after which holders of founders' shares were entitled to take one-third to one-half of the remaining profit. Founders'

² American Tube Works v. Boston Machine Co., 139 Mass. 5.

shares usually were a small percentage of the total capital stock.

Debenture Stock. This also is an English term, and it relates to a debt of the company and not to an interest in the proprietorship thereof. The word "stock" as here used is not synonymous with the like word in such terms as "common stock," "preferred stock," and "stock," etc. English corporation finance uses the terms "shares" and "stock" in a sense which differs from ours. The capital of the company is divided into shares of a certain number and amount; these shares are, in fact, shares of stock as we have them. The company may then convert paid-up shares into a general capital stock to be divided among the shareholders in proportion to their respective interests therein; in other words, capital stock is the aggregate of shares, and similarly "debenture stock" is the aggregate of debentures. Shares are dealt in according to their specific denominations, which are most commonly £1 and £5. Stock can be dealt in and transferred in fractional parts, usually in multiples of one pound, but sometimes even less. (See also § 102.)

CHAPTER VII

DIVIDENDS

§ 60. Declaration of Dividends

A dividend is "a portion of the principal or profits divided among the several owners of a thing."¹ Thus, the distribution of assets upon the dissolution of a corporation, or the settlement of a bankrupt's estate, is spoken of as the payment of dividends. In corporation finance its ordinary use relates to the distribution of profits among the stockholders.

A dividend is declared when an amount is set aside out of the net profits as a fund to be divided equally among the shares of stock and to be paid to stockholders in proportion to their holdings. The declaration must be made by the directors, who, at the time of declaration, prescribe the conditions under which and the times at which they shall be payable to the stockholders. The directors alone have this power and they may exercise it in their discretion; their judgment alone governs. In effect, the declaration and payment of dividends constitutes a parting with some of the corporate assets, and it should be authorized by formal and specific action of the board of directors—who are the trustees of the corporate property—at a meeting lawfully and regularly assembled. If it were permissible to declare dividends without such a meeting of directors to afford opportunity for deliberation and interchange of opinion, and to place upon record the details of the action taken, the interests of the stockholders or of some of them might be jeopardized. There are other countries where the shareholders have a more immediate control over the declaration of dividends, which are declared at general stock-

¹ Bouvier's Law Dictionary.

holders' meetings when reports of directors and officers are heard and acted upon. The better method, however, is undoubtedly that of placing the responsibility solely upon the directors and holding them strictly to the duties of their trusteeship. Shareholders too often look to the present alone and consider their own interests, while they lack the intimate knowledge of corporate affairs which would enable them to act with as much wisdom and prudence as the directors.

§ 61. Dividends Out of Surplus Profits

It is a general rule that dividends must be paid only out of surplus profits. The very definition of the term implies it. The New York Stock Corporation Law prohibits the declaring of, and the Penal Law makes it a misdemeanor to declare, dividends except from the surplus profits arising from the business of such corporation, or to "divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of such corporation or reduce its capital stock, except as authorized by law."

To say that dividends must be paid out of profits is to say that they must not be paid out of capital. Those who advanced the means of acquiring that capital, whether through purchase of stock or bonds, were investing in an enterprise which seemed to afford opportunities for profit; they were not merely making a deposit with the company. They may rightfully expect, therefore, that the entire capital shall continue to be devoted to the operations for which it was intended, except, of course, as losses may make inroads therein. Any diversion of the capital to any other purpose whatever will prejudice the rights of both shareholders and creditors, as well as of the public which is dependent upon the service.

The exercise of care to prevent the diversion of capital to the payment of dividends is necessary for the protection of all parties dealing with or interested in the corporation.

Where a corporation has issued some of its shares of capital stock to bona-fide purchasers for value and other shares in exchange for property or services grossly overvalued, the division of capital in the guise of dividends is tantamount to dividing part of the money of the bona-fide stockholders among the others. The favored stockholders may thus make a considerable profit resulting not at all from the operation of the corporate enterprise, but rather through the perversion of the corporate object. Or, instead of one group of stockholders profiting out of the losses of another group, the entire body of stockholders may be thus favored at the expense of bondholders; the continued apportionment of capital as dividends will lead to bankruptcy, and the creditor or bondholder who thought his claim was amply secured will find that his money has been transferred to the stockholders, that the security has been dissipated, and that he has been remanded to a lien on a depreciated, worn-out, and obsolete plant. It is well to note that precisely this situation has often developed through poor accounting where there has been no wilful purpose and the intentions of the management have been most worthy. If the corporation is engaged in public service, the community, of course, will either lose the service altogether or else will have to get along with the poor service possible under such circumstances.

In the United States, statutory regulation of dividend distribution has been notable mainly for the absence of definite provisions, and public service commissions themselves have not been accorded specific powers in this respect; legislators have been reluctant to deal with this part of corporate finance, and, without question, they have thus followed the wisest course pending the standardization of accounting procedure. In some other countries the subject has received more consideration. We have already referred to the German Commercial Code which makes detailed provision for the preparation of the annual balance sheet, directing the basis upon which inventory

shall be taken (at market value, if available, or else at a value not exceeding cost). A very interesting part of this Code is that which attempts to provide for the permanency of dividends by requiring certain reserve funds to be kept. It is high time that the public here realized that regularity and adequacy in payment of dividends on the invested capital of stockholders is just as much a matter of public interest and benefit as the payment of principal or interest on bonds, or the prompt payment of any commercial or banking obligation.

§ 62. Determination of Surplus

The determination of what constitutes surplus profits properly apportionable as dividends is a difficult matter and goes deeply into accounting theory and practice. Surplus is the excess of assets over liabilities; the contrary situation—an excess of liabilities over assets—denotes a deficit. A statement summing up the assets and liabilities at any one time is the balance sheet of the business. This balance sheet could be constructed in either one of two ways:

First, by assembling all the assets, i.e., the values of the different elements of the corporation's property and the amounts of its collectible and valid accounts or other claims, and then all the liabilities, i.e., the amount of its various money obligations (including the nominal liability on capital stock). This is the inventory method and is the foundation of all accounting systems.

Second, a balance sheet having been once prepared, another one for a later date may be constructed by tracing through the accounts and records of the business the changes of values since the date of the last preceding balance sheet, summarizing the net balances affecting the assets on the one hand, and the obligations on the other. This method comprehends the whole system of corporate accounting.

The inventory method as a continuing practice is possible only in the case of a very small business or under exceptional

circumstances; in the case of large corporations it involves costs so heavy and labor so considerable as to be justifiable only on rare occasions and for special purposes, hence the necessity of correct accounting as a part of corporate finance.

§ 63. (1) Importance of Correct Accounting

There are many corporations today which have never kept their books in such a way that a correct statement of assets and liabilities can be drawn from them; their true financial status is therefore not known to the stockholders. Such a corporation may go on for years showing apparent profits and distributing dividends, while it is, as a matter of fact, accumulating a deficit instead, so that some, at least, of dividend payments made during the interim were apportionments of capital and not of profits. The interests of stockholders, creditors, and the community are in jeopardy where this situation obtains, even though it may have arisen wholly out of ignorance and without the slightest intention to deceive. It becomes much more serious in its possibilities where expert accountants and an elaborate accounting system apparently capable of a correct showing are intentionally used so as to misrepresent the financial condition of the corporation. The aim and purpose of a great deal of work done by regulating commissions in prescribing uniform accounting systems and requiring other corporate records to be kept has been that of assisting corporations to understand their own affairs better, and by the formulation of uniform practices to minimize the possibility of misstatement.

§ 64. (2) Balance Sheet, Income Statement, and Profit and Loss Account

The balance sheet shows the financial status of the corporation as of a particular instant; if it portrays the status of an operating corporation its representations will be modified by the result of operations even before all of the figures have

been summarized and written down. A balance sheet might be made up for each day, and each one would differ from all the others. A statement of the results of operations is therefore a necessary adjunct of each balance sheet to indicate the causes which have brought about the changes in assets or liabilities, or which, in other words, have produced the present figure of corporate profit or loss. This statement is the Income account of the corporation; it is usually made up on a yearly basis and it includes the revenue accounts, the revenue deduction accounts, i.e., the operating expenses, taxes, and uncollectible bills, and the income deduction accounts, i.e., fixed charges of interest, rents, and other contractual payments. Its ultimate figure is the net corporate income—the excess of total income over total deductions, or the net corporate loss—the excess of total deductions over total income.

The net corporate income or the net corporate loss adds to the accumulated surplus or deficit. That surplus or deficit, however, is itself subject to adjustments through gains (e.g., gifts, profit realized upon the sale of investments, etc.) or losses (e.g., losses suffered upon the sale of investments, extraordinary casualties, and dividends which draw from surplus); these are items which cannot be said to constitute income or deductions from the income or which are in adjustment of the net corporate income of a prior period since merged in the total corporate deficit or surplus. These changes in the amount of surplus or deficit are recorded in a Corporate Surplus or Deficit account, better known by its time-honored designation of the "Profit and Loss" account.³

There are, then, three groups of accounts among which no confusion should occur, for each represents a separate class of

³ In the enumeration of items to be included in the respective groups, the general outline of the Uniform Systems of Accounts adopted by the Public Service Commissions of New York and the Interstate Commerce Commission has been followed. Concerning some of the items there are differences of opinions as to the groups in which they should be entered. It must also be noted that the use of the "Profit and Loss" account here described in the practice of public service corporations is very different from the practice of manufacturing or mercantile corporations where the "Profit and Loss" account also includes all the items which here are grouped as the Income account, and itself does not appear upon the balance sheet but is closed out into an account "Proprietorship."

facts. The balance sheet shows the facts of present assets and liabilities and thus measures solvency as of its date; the Income account shows how much was made or lost in the operations of the period covered, while the Profit and Loss account takes up the net corporate income or loss and combines it with the net balance remaining from all operations prior to the present Income account, makes necessary adjustments, and shows how much of profit remains on hand, or what is the aggregate amount of loss. The last two groups of accounts perform parts of the one function of explaining changes in solvency, indicating no subsisting facts, however, all of which it is the sole function of the balance sheet to report.

Confusion in classifying the items between these accounts, if not intentionally brought about, arises most often through misunderstanding or ignorance of the distinction between fixed and floating capital, of expenditures for betterments, replacements, and renewals of capital, of the nature of depreciation, or through errors in valuation of various assets. A full discussion of the proper methods of obviating these difficulties is more appropriate to a treatise on accounting than it is to a study of this kind, and only the essential principles to be followed can be suggested herein.

§ 65. (3) Real Surplus Distinguished from Book Surplus

Surplus is thus seen to be essentially a product of the balance sheet, and its proper determination becomes a question of correctly stating the balance sheet. It was said above that the balance sheet measured the solvency of the corporation. That was a correct statement of its function, but at the same time it was the statement of an ideal rather than of present attainment in most cases. The measure of solvency is the difference between the *actual available value* of the assets and the amount of the subsisting debts and claims owed by a corporation. A part of this difference will represent the original investment of the stockholders, and if that is deducted, the net

remainder is the amount of *real surplus*. If the difference between the value of assets is less than the allowance which should be made for original investment of the stockholders, instead of surplus there is a deficit. It becomes necessary, therefore, to distinguish between *real surplus* and *book surplus* in all cases where the balance sheet does not or cannot show the actual available value of the assets, and this it does not and in large measure cannot do in the case of public service corporations.

The most important item of assets of a public service corporation is its plant, or fixed capital in service. The manner in which this asset should be taken up on the balance sheet is discussed in Chapter XVI, where the conclusion is reached that it is impracticable, not to say impossible, to carry this asset at any figure which could be said to be the actual available value thereof; in the absence of any better method, it is recorded at its original cost. Of course, as any part of the fixed capital is sold and the value becomes known (the sale price being the value) and realized upon, the excess or deficit of that from cost will be promptly taken into the accounts and will pass into the "Corporate Surplus or Deficit" account. The cost at which fixed capital is carried on the books may be either more or less than the real value, but the reader of the balance sheet must supply his own data to arrive at the real value, or obtain the opinion of an expert analyst. The only respect in which the balance sheet will indicate any divergence from the cost will be as it reflects the allowances for the known incidents of use which operate to decrease values; for instance, the wear and tear which must be repaired and is made good through the current operating expenses, and the irreparable wear and tear, the obsolescence or inadequacy, which will in time cause the retirement of the capital, requiring that in the meantime adequate provision be made against the contingency. This most important asset, therefore, is seen to have a book value at which it appears upon the balance sheet, and also a

real value which does not appear from any financial statement drawn from the accounts. Correspondingly, there is a book surplus appearing upon the balance sheet, and available for the purpose of dividends, and also a real surplus which is not currently available and can be made so only upon the contingency of a sale of the property or a definite and authoritative appraisal thereof.

For many large corporations the assets of greatest importance next to fixed capital are the investments. Investments often depreciate in value rapidly and substantially. If their valuation were placed and kept at original cost, the surplus might at times be considerably overstated or understated because of the depreciation or appreciation in value of the securities held. Again, if an attempt is made to revalue these investments periodically upon the basis of market prices, adjusting surplus to correspond, not only will surplus be subjected to rapid fluctuations, but the opportunity may be seized to bolster up surplus for the distribution of dividends. Moreover, by far the greater portion of investments of public service corporations are in the stocks and bonds of subsidiary and controlled corporations—in many cases the investment comprises the whole issue of such stocks or bonds, so that there is not a sufficient part thereof upon the general market to determine values. Even if there were, manifestly the values would be determined to a large extent, if not altogether, by the operating policy and success of the controlling corporation which is also the investor, so that it could manipulate values for the purposes of revaluing its holdings. Where such stock is held for the purposes of control, obviously the holding company is estopped from parting with the stock, else it would lose control; the further question arises, then, whether or not a corporation holding such stock can be said to have its investments increased in value when it is in no position to realize the appreciation. Manifestly no rule can be formulated as to the basis upon which investments shall be valued

for accounting purposes, and reliance must be placed upon the honesty of the corporation in stating its investments at a fair valuation. The practice approved in official accounting orders applying to public service corporations is that investments should be carried at cost, but depreciation may be written off, while the writing up of appreciation is not usually allowed.

§ 66. (4) Manipulation of Surplus

There are a great many ways in which the balance of surplus may be manipulated; although at times the purpose of the manipulation is to secure understatement, the most frequent attempts are to secure overstatement. When he is confronted with a situation where dividends must be paid, even though earnings have been insufficient, the shrewd financier will invent innumerable means of developing an apparent surplus, taking his chances on future earnings making good the withdrawal of capital. All of these many forms, when analyzed, can be shown to be either the overstatement of assets and the understatement of liabilities, or the swelling of revenues and shrinking of operating expenses.

There can be little opportunity for the manipulation of cash account and of accounts or bills receivable records. Where, however, the latter represent accounts or bills receivable from system corporations or related interests, both opportunity and motive for manipulation may exist at times; it is desirable, therefore, that accounts and bills receivable from system corporations should be separately shown upon the balance sheet. Official forms for annual reports to commissions usually make provision for the separate statement of all such items.

It is seldom that the total amount of materials and supplies on hand and not yet consumed in the operations of public service corporations becomes sufficiently large to affect materially the determination of corporate solvency. In an inventory of these materials and supplies the valuation should

ordinarily be based upon cost prices or upon prevailing market prices provided these do not exceed cost. This is the customary practice of all conservative accountants.

A method sometimes used to swell revenues artificially has been through the use of interdepartmental accounts, crediting one department for services alleged to have been rendered to another and then so manipulating the entries as to show the constructive departmental revenues as being revenues of the corporation. For instance, the operating department will render services to the construction department, making a charge for the service; the constructive payment is charged to the capital account and if the constructive revenue is credited to the usual revenue accounts, the net corporate income will be greater than it should be by the excess of the amount charged for the service over the cost of rendering the service. Of course, if the service is bona-fide, the transaction is a proper one, but the charge must not exceed the cost (estimated, if not known) to the operating department, and the amount must not be credited to revenue accounts but to operating expense accounts, with the result that the operating accounts are relieved entirely from the cost of service which has been accounted for in the capital accounts.

To shrink expenses, an attempt is often made to hold in suspense items of operating expenses, on the plea that they are applicable to future periods and should not be made to burden the revenues of the present.

So far as the accounting of public service corporations has come under the supervision of public authority, efforts have been made and are being made through the enforcement of correct accounting principles to prevent such abuses. Much more can be accomplished, however, through the insistence of stockholders that their directors shall deal honestly with them so that payments purporting to represent dividends shall really represent a distribution of the surplus profits and not of capital.

§ 67. Amount of Surplus Which May Be Divided

The question of what constitutes "profits" within the meaning of statutes has proved very perplexing. The foregoing paragraphs have described difficulties in arriving at a correct figure of corporate surplus even where the accounts are regulated. At best, the final result of all the accounting is only a "book surplus." Is it this figure that must control the distribution of dividends if the statute is to be observed? Or may the corporation make up a statement of "surplus profits" apportionable as dividends, omitting therefrom or substituting therein different amounts for some items which went to make up the book surplus?

One important question is whether the statute permits the profits of any one period to be apportioned for dividends if there also exists a deficit balance from the operations of preceding years, or if it requires that these profits be first applied to making good the impairment of capital resulting from past operations. Then, again, if the accumulated deficit must be made good before the profits earned in any one year may be distributed as dividends, may any distinction be made between the impairment of capital which was caused by losses incurred in operation or by adjustments in value of capital assets?

Courts have often been called upon to say whether or not certain dividend payments represented the apportionment of surplus profits or of capital. It is impossible, however, to marshal the decisions into the statement of one specific rule. The United States Supreme Court has declared that "there is no difficulty in ascertaining the amount of such profits in any year," referring to "that portion of the net earnings of the company which legitimately constitute profits and could be rightfully apportioned or distributed among shareholders."³ The court in this case approved the rule laid down in an earlier decision to the effect that "net earnings are properly the gross

³ *Mobile and Ohio R. R. v. Tennessee*, 153 U. S. 486 (1894).

receipts less the expenses of operating the road to earn such receipts. Interest on debts is paid out of what thus remains—that is, out of the net earnings. Many other liabilities are paid out of the net earnings. When all liabilities are paid, either out of the gross receipts or out of the net earnings, the remainder is the profit of the shareholders, to go toward dividends, which, in that way, are paid out of net earnings.”⁴

English Court Decisions. Some of the decisions rendered by the courts of England have contained very interesting discussions of these questions; two opinions written by Judge Lindley of the Chancery Division are especially valuable. In one case he wrote:

“The word ‘profits’ is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavoring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.

“ In order to show what has been subscribed by the shareholders and what has become of the money so subscribed, and to show the results of the company’s trading or business, it is practically necessary to keep a capital account and what is called a profit and loss account, and as a matter of business these accounts ought to be kept as business men usually keep them. Accordingly, we find provisions for keeping such

⁴ *St. John v. Erie Ry. Co.*, 10 Blatchford 279; *aff’d*, 22 Wall. 136.

accounts in Table A in the Appendix of the Companies Act, 1862, and in the articles of association of most, if not all, companies. But there is no law which compels limited companies in all cases to recoup losses shown by the capital account out of the receipts shown in the profit and loss account, although care must be taken not to treat capital as if it were profit.”⁵

In an earlier case Judge Lindley had presented the following illustration and argument:

“Suppose a company is formed to start a daily newspaper; supposing it sinks £250,000 before the receipts from sales and advertisements equal the current expenses, and supposing it then goes on, is it to be said that the company must come to a stop, or that it cannot divide profits until it has replaced its £250,000, which has been sunk in building up a property which if put up for sale would perhaps not yield £10,000? That is a business matter left to business men. If they think their prospects of success are considerable, so long as they pay their creditors, there is no reason why they should not go on and divide profits, so far as I can see, although every shilling of the capital may be lost. It may be a perfectly flourishing concern, and the contrary view, I think, is to be traced to this, that there is a sort of notion that the company is debtor to capital. In an accountant’s point of view, it is quite right, in order to see how you stand, to put down company debtor to capital. But the company does not owe the capital. What it means is simply this: that if you want to find out how you stand, whether you have lost your money or not, you must bring your capital into account somehow or other The company is not debtor to capital; the capital is not a debt of the company.

“Having shown from the Acts (negatively, of course, because this is a negative proposition, and can only be proved by looking through the Acts) that the Acts do not require the

⁵ *Verner v. Gen'l, etc. Trust, L. R. Ch. D. (1894), Vol. 2, p. 239 (266).*

capital to be made up if lost, I cannot find anything in them which precludes payment of dividends so long as the assets are of less value than the original capital.”⁶

“It is easy to lay down as an abstract proposition that you must not pay dividends out of capital; but the application of that very plain proposition may raise questions of the utmost difficulty in their solution,” wrote the Earl of Halsbury, L. C., setting forth his decision in a case which had gone to the House of Lords on appeal. “Even the distinction between fixed and floating capital, which may be appropriate enough in an abstract treatise like Adam Smith’s ‘Wealth of Nations,’ may with reference to a concrete case be quite inappropriate.” Continuing, he says:

“As an illustration of what difficulties may arise the example given by the learned counsel of one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnership, is one which one would have to deal with. On the one hand, people put their money into a trading concern to give them an income and the sudden stoppage of all dividends would send down the value of their shares to zero and possibly involve its ruin; on the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital. But what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do I for one decline to express an opinion not called for by the particular facts before us; I am the more averse to doing so, because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a Court of Law.”⁷

⁶ *Lee v. Neuchatel Asphalte Co.*, L. R., 41 Ch. D. (1889), 20 (22).

⁷ *Dovey, etc. v. Cory*, 1901 L. R. (A. C.) 477 (486).

Summary. The American and English courts do not seem to be far apart in the interpretation which they place upon the statutes requiring payment of dividends out of surplus profits only. It may be said that in general they have emphasized the reality of actual profits on hand in the particular case before them and have not dealt very much with the accounting aspects; if the receipts leave a balance on hand after taking care of the expenses, taxes, etc., they have upheld the distribution of dividends. The writer does not know of any case which has involved the question of the effect to be given to accounting rules established by regulating commissions, and it still remains to be seen whether the courts will insist upon a book surplus as the basis of dividends by these regulated companies. The commissions themselves have not made any rulings on the subject, providing for the deduction of dividends either out of the net incomes or the accumulated surplus.

From a business standpoint, the entire amount of surplus should not, as a general proposition, be divided among the stockholders. The corporation should at all times maintain a reasonable surplus to support its general credit, to maintain continuity of dividends, and to meet unforeseen contingencies.

§ 68. Dividends in Relation to Wasting Assets

A somewhat different rule from that above described obtains in the case of dividend payments representing in part the exhaustion of wasting capital. The only class of public service corporations subject to these considerations are those engaged in the production and distribution of natural gas. Manifestly the proceeds of the sale of natural gas should include not only the operating costs and profit on investment but also such a proportion of the cost of acquiring and drilling the wells, i.e., of the fixed capital, as will represent the cost of the gas *in situ*; hence the excess of revenues over operating expenses, taxes, and deductions does not represent profit alone but includes a return of the original invested capital. The

principle is the same as that applicable to any other operation, i.e., the cost of the product always includes something for the destruction of fixed capital as well as the cost of material consumed and labor expended. The distinction, such as there is, is one of degree. In this case, however, because of the uncertainty of the quantity of gas in the wells, the actual proportion of the original investment so returned cannot be determined, and, should the whole amount of the excess of revenue over deductions be distributed as dividends, the amount of dividends will represent in part the distribution of capital. Yet this is considered proper in view of the temporary nature of the venture and due to the character of the natural resources invested in. Such a venture is a wholly speculative one and investors in the stock of the corporation are well aware of the nature of the undertaking, if they have acted at all intelligently. Since the duration of the supply is unknown, the logical policy of the corporation would seem to be to distribute among its stockholders the proceeds of the venture as fast as these come in; the aim being to return to the investors as quickly as possible the amount of their investment, limiting speculation as to profits to the possible supply which may remain after the original investment of the stockholders has been safeguarded. This seems to be wholly logical and its justification has been definitely recognized by the courts. Creditors' interest should, of course, be protected.

There are those who contend that these enterprises should be regarded as permanent, the capital of which should be maintained. This means that depreciation appropriations should be large enough to raise a reserve to make good the entire cost of each well as it becomes exhausted.

§ 69. Stockholders' Title to, and Remedy for, Undivided Profits

Until declaring a dividend, the corporation holds all the profits of its operations precisely as it holds any other corpor-

ate property. The stockholders do not acquire any vestige of legal title therein different from their general and undivided interest in the corporate assets as a whole. It is entirely within the powers and privileges of the directors to apply to the increase of the permanent corporate assets, in extensions of its plant or operations, etc., all or any part of the profits accruing from the use of the capital theretofore invested, i.e., to build up the capital out of earnings, instead of dividing the earnings among stockholders; provided, of course, that such withholding of corporate dividends is made in entire good faith.

Under many circumstances the practice of building up capital out of earnings (i.e., out of income) is a commendable one. It is a matter, however, of which both the public and the stockholders are entitled to accurate knowledge. The public is interested in knowing how much of the fixed capital reported by the corporation has been contributed by the security holders, and how much has been added from the earnings of the business. The stockholder is interested because the application of earnings to additions and betterments represents an increase of assets in proportion to which he may add to the valuation of his holdings. To show this information the accounting classifications and report forms of the Interstate Commerce Commission introduce, among the accounts of carriers showing the disposition of Net Income or Surplus, accounts entitled "Income (or Surplus) Appropriated for Investment in Physical Property." Appropriations for additions to and betterments of road and equipment, or for the construction of new lines or extensions, are debited to these accounts, while concurrent credits are made to a balance sheet account, "Additions to Property Through Income and Surplus," if already expended, or to "Appropriated Surplus Not Specifically Invested" if unexpended. A glance at the income statement will thus show what portion of the earnings for that period has been appropriated to the building up of capital,

and the balance sheet will as readily show the total earnings appropriated to date, together with the separation between expended sums and unexpended balances remaining available.

It has been shown before that the full legal title to all assets is in the corporation, and the beneficial interest of stockholders is purely equitable, not legal; hence, a stockholder may not maintain an action at law for the recovery of a portion of the undivided surplus, just as he may not maintain an action for the apportionment to himself of a proportion of the capital assets of the corporation. Any right that the stockholder may have, therefore, of compelling the declaration and distribution of dividends, is also purely equitable, not legal. As soon as profits are divided and declared as dividends, they at once become the property of the several stockholders in proportion to their respective holdings; thereupon any stockholder may maintain an action at law for the recovery of the property to which he has become legally entitled, should the corporation refuse to pay it to him at or after the time of payment specified in the resolution of the directors declaring the dividend.

While it is within the rights of the stockholders to maintain an action in equity to compel the declaration of dividends, courts of equity have proved themselves loath to review the action of directors in declaring or refusing to declare dividends, except where the refusal is tainted with fraud or arises out of the attempt to manipulate the corporate affairs so as to favor one class or portion of stockholders at the expense of another, or where a distribution has been made for some class of stock contrary to the statutes or charter provisions. The majority stockholders control the machinery of the corporation, and in appointing representatives to direct the corporate affairs they impose upon themselves and all other stockholders the obligation to be bound by the acts of their representatives committed in the recognized course of their duties. If they become dissatisfied with those representatives, they have the necessary power to oust them. Naturally, there

would need to exist very peculiar circumstances to justify the majority stockholders in invoking the aid of the court against the acts of the directors; a minority stockholder, on the other hand, has voluntarily entered into a relationship where his interest is subject to the control of others, hence it is entirely proper that courts should hesitate to relieve him from the burden of his contract unless fraud or unconscionable dealing be alleged of the other parties to the contract.

§ 70. Mediums of Distribution

Undivided profits mingle with and increase the value of the other assets; they, therefore, correspondingly increase the value of the shares of stock. Upon distribution as dividends, the corporate assets decrease and the value of each share goes back to what it was before the accumulation of the profits, assuming the absence of other forces affecting the value of stock. (The intrinsic value, not the market or par value, is here referred to.) In effect, then, to declare and pay dividends is to make readily available to the stockholder a portion of the property in which he theretofore has had only a beneficial and contingent interest—it changes his beneficial interest into real ownership. The manner in which this is done is immaterial; the division can be made in actual apportionment of property, if that is practicable, or in any other form sufficient to accomplish the purpose. A number of methods have been adopted and used; dividends have been declared and paid in cash, in scrip, in certificates of indebtedness (scrip or bonds), or in property. To carry out the general principle of dividend payments, the method used must be such as to make readily available to the stockholder the proportion of profits allotted to him, otherwise little will be accomplished since he was already possessed of the beneficial ownership in the profits remaining undivided in the hands of the company. The operation of this rule is, of course, subject to the dictates of expediency.

It is sometimes asserted that affirmative authority, by statute or charter, is required for the payment of dividends in any form other than cash. The generally accepted rule has been, however, that so long as the profits have been actually earned, the question of whether dividends shall be paid in cash or otherwise, in the absence of statutory enactments (of which there are few) or specific provision of charter or by-laws, rests entirely in the discretion of the directors. A holder of common stock is not privileged to demand the apportionment of dividends to himself in any particular form. It is probably true, however, that in the absence of specific agreement the holders of preferred stock entitled to dividends at a stipulated rate are privileged to demand payment in cash.

The payment of dividends in rights or property other than money, is resorted to where the profits earned are sufficient for the purpose of dividends but have been converted into some kind of property used in the business so that they are not available for distribution in cash. If profits so tied up had to be distributed in money, the corporation would probably need to borrow the sums necessary for that purpose. Borrowing money to pay dividends is often considered a suspicious practice, but it is not necessarily so; if profits have been actually earned and the loan can be soon repaid so as not to make the interest burden unduly heavy, the practice is a proper one. But where the profits are tied up and the circumstances are such as not to warrant the use of borrowed money, the distribution of those profits may be accomplished by the declaration of dividends payable otherwise than in money.

"It is apparent that where the corporation, instead of disposing of the property in which the profits have been invested and then paying the dividends from the proceeds, prefers to retain the property and postpone payment to the stockholders, it is reserving the property from which it is fair to assume it earns a return sufficient to discharge in whole or in part the interest upon its dividend obligation. Moreover, it had the

right, if it so elected, to borrow the money with which to pay dividends where it had invested the profits in improvements at least equalling in value the dividends declared, so that interest in that event would equally be a charge before further dividends could be declared as of earnings.”⁸

§ 71. Cash Dividends

Cash dividends are the rule; it is the most equitable and convenient medium, making most readily available to the stockholder the portion of profits to which he has become entitled. The certificate of incorporation may specifically provide that dividends be paid only in cash, and the requirement will, of course, be binding upon the corporation so that a stockholder will be under no obligation to accept payment in any other form. Even in the absence of any provision, dividends on preferred stock are almost always paid in cash.

Instead of paying dividend warrants at its own office, a corporation may deposit a sufficient sum with its fiscal agent, usually a banking corporation. It will then notify the stockholders that such a deposit has been made, usually sending to each stockholder a certificate or check which can be redeemed at the office of the depository. Having done so, the corporation declaring the dividend practically transfers the primary liability to the fiscal agent, itself remaining only secondarily liable; to hold the corporation to its secondary liability, therefore, the stockholder should present the check to, or make proper demand upon, the fiscal agent within a reasonable time.

§ 72. Scrip Dividends

Scrip in financial transactions denotes a temporary paper or certificate redeemable later in money or exchangeable for some permanent certificate or whatever else the scrip may entitle the holder to receive; accordingly, a scrip dividend is a dividend in the form of certificates exchangeable at a later

⁸ *Bankers Trust Co. v. Dietz Co.*, 157 A. D. (N. Y.) 594 (1918).

determined or determinable time, or at the option of the company, for money, shares of stock, certificates of indebtedness, or other property.

A scrip dividend divides the profits but defers the actual distribution of assets. The declaration of scrip dividends is practically notice that a certain amount of profits has been transferred to the principal of the capital fund or is represented by assets which cannot be immediately converted into cash. If the scrip is redeemable in cash its effect is to declare an actual dividend but with a postponed date of payment. This date may be certain, so that the scrip becomes a fixed obligation, or it may be contingent and payable, for instance, as soon as the company accumulates sufficient surplus funds for the purpose, or when specific property upon which the scrip is based shall be sold. If the scrip is a fixed obligation it will be substantially the same as a bond dividend, except that it will not earn interest. Sometimes the scrip is given the right to participate in future dividend distributions; it then partakes much of the nature of stock except that it carries no voting power.

Scrip is designated as "convertible" if it is made exchangeable for stock or bonds of the company. If it is so convertible it can be considered as a mere incident of a bond or stock dividend and subject to the same considerations which govern those methods of dividend distribution.

If the profits have been earned and have been used in extending the operations or have in some way become tied up so that they cannot actually be taken out, it may be assumed that the investment of the stockholder is so much bettered, but the situation is just the same whether a certificate is given him to evidence his added interest or not, save, of course, as it makes it possible for him to realize something upon the sale of the scrip. The device, nevertheless, permits the corporation to claim that it has maintained dividends and at least lessens the disappointment of stockholders.

It may be used, on the other hand, to evade a statutory prohibition, for instance, that against the payment of dividends above a certain rate; or it may be intended to avert public criticism of an exceptionally liberal dividend. For these purposes, however, the more direct device of a stock dividend is most usually resorted to.

§ 73. Bond Dividends

A bond dividend represents the apportionment of profits among the stockholders, but instead of paying the dividend in cash, the issuing corporation creates a claim against itself for the amount of the dividend and in favor of the stockholder, to whom it issues a certificate setting forth the claim. Upon maturity, the debt is payable in cash while in the meantime it is entitled to interest which becomes a fixed charge against the company to be paid whether further profits are earned or not. A bond dividend is thus essentially a forced loan; the stockholders would undoubtedly prefer cash but are compelled to take evidences of indebtedness instead; they receive the certificates acknowledging a loan to the company, but they had nothing to do with the making of the loan.

A bond dividend represented by interest-bearing certificates, unlike a scrip or stock dividend, does vest in the stockholder a claim or interest which he did not theretofore possess, viz., the interest of a creditor and the claim for interest. This latter claim, however, may represent an advantage gained at the expense of another class or other classes of stock; the bond dividend is declared upon one class with the effect of increasing the company's fixed charges, the profits in the distribution of which the other classes of stock may participate will be reduced, while the holders of the favored shares have their bond holdings to look to for income.

Statutory Enactments. Bond dividends are sometimes, like stock dividends, prohibited by statutory enactments. Such a prohibition has been read into the provisions of the

Public Service Commissions Law of New York defining the conditions under which the Commission might authorize the issue of securities by a corporation, to wit, "when necessary for (1) the acquisition of property, (2) the construction, completion, extension or improvement of its facilities, or (3) for the improvement or maintenance of its service, or (4) for the discharge or lawful refunding of its obligations."⁹ The Erie Railroad Company in 1907 declared a dividend of 2 per cent upon the first preferred stock and 4 per cent on the second preferred stock, these dividends aggregating \$1,596,848. Stating that "in the judgment and determination of this company it is inexpedient and is incompatible with the best interests of the company and of its stockholders that such dividends, though earned, on the first preferred stock and second preferred stock, should be paid presently in cash in view of the pressing and dominant demands for cash for the extension and improvement of the railroad heretofore and now in progress," the directors ordered that dividend warrants, running for a term of ten years, and drawing interest at the rate of 4 per cent per annum, be issued in lieu of a cash dividend. The Public Service Commission, acquiring jurisdiction under the statute quoted, refused to authorize the issue of these warrants, holding that: "If this section is to be construed as not permitting the corporations named therein to issue any evidences of indebtedness whatever except for the purposes named therein, and permitting long time indebtedness to be incurred only for such purposes, then the declaration of a dividend payable in the future is not now warranted by law." The argument leading to this conclusion is worth while quoting at length:

"The warrant in this case is not to be issued for the discharge of an obligation but as evidence of the existence of an obligation which directors create at the time of issuing of

⁹ It should be noted that this case was decided prior to the amendment of 1910 which permitted capitalization for the purpose of reimbursing income. Some of the statements will need to be interpreted with this fact in mind.

the warrant without securing anything therefor. This is opposed to the whole theory of the statute, which, from every possible point of view, requires the securing by the company of some value or property which it did not before possess by reason of the issuing of its evidence of indebtedness. . . .

“A dividend is the dividing of property among the stockholders; it is the direct opposite of the securing of capital. It is parting with it. A promise to divide in the future is simply a promise to part with that property in the future. The corporation secures nothing by the dividend. After declaring the dividend it possesses no capital which it did not possess before. The money which it promises to divide at a future time still remains the money of the corporation. It can be applied to any lawful purpose of the corporation at the discretion of the directors, and after the declaration of a dividend payable in the future it has no more power or authority over the fund which it promises to divide than it had before the declaration of a dividend. Every dollar of the money or property which warrants the declaration of such a dividend is already the property of the company and nothing new is secured thereby. . . . It is clear that warrants evidencing a scrip dividend cannot be issued under that section for the plain reason that no capital is secured thereby. Nor can the issuing of such warrants be necessary for one of the purposes enumerated in the statute, for the equally plain reason that after their issue the directors have no power to apply the surplus to one of the required purposes other than they possessed before the declaration of the dividend. Nothing can be justly said to be necessary in this connection unless its existence is required to enable something to be done which would otherwise be impossible. By the declaration of a dividend payable in the future no part of the surplus has been transferred to the stockholders. The directors themselves have no more and no less power over it than was possessed by them before the declaration of the dividend. The making of such a dividend is not a loan by the

stockholders to the company. Such a thing as a loan cannot be without receiving something from the stockholders and with their consent, and that is not the case. A scrip dividend is a mere promise to pay something to the stockholders in the future. Absolutely nothing is received from them and nothing is taken from the company at the present time. In its essential nature it is nothing but a promise to pay to the stockholders at a future time a sum of money, and for this promise it receives no consideration whatever. How can such a promise be said to be necessary for any purpose?"¹⁰

Other statutory provisions regulating the issue of scrip and bond dividends are discussed below in connection with stock dividends.

§ 74. Stock Dividends

A stock dividend also represents the apportionment of profits among the stockholders, but, unlike the scrip or bond dividends, makes no provision for an actual distribution in cash at any time; the evidence of the apportionment of profits as dividends received by the stockholder consists of additional shares of stock issued for the amount of the dividends.

Since the beneficial ownership of a stockholder takes in all the corporate assets, including all profits earned and remaining undistributed, it follows that the value of the entire interest of the stockholder is the same before as after the declaration of a stock dividend; the declaration merely changes the form of the evidence of the stockholder's interest by increasing the number of shares while lessening the actual value per share, the aggregate value of the entire interest remaining unchanged. It adds nothing to the capital of the corporation, nor to the ownership of the stockholder. The issue of new shares, however, does make it possible for the stockholder to realize cash to the amount of the dividends by selling the additional shares, leaving his interest as before.

¹⁰ *Matter of Erie R. R. Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 115.

If he retains the shares issued to him as a stock dividend, the total amount of stock sharing in dividend distributions is correspondingly increased, and if dividends are maintained thereafter at the same rate as before, his future dividend income will be so much larger. Frequently dividends have been paid in stock so as to increase the amount of capital stock upon which future dividends will be declared, and so that the actual rate of these other dividends might be expressed as 6, 8, or 10 per cent instead of 12, 16, or 20 per cent upon the smaller capitalization. This is done where it is feared that the higher rates will invite agitation for the reduction of charges, extension of service into unprofitable territory, etc.

Much of what has been said of scrip and bond dividends applies also to stock dividends. Stock dividends have been much more common than either bond or scrip dividends, and have been subjected to much more litigation and legislation. In some states, as in Massachusetts, stock dividends are specifically prohibited. The statute of New York State, already quoted, has been interpreted by the Public Service Commission of the Second District to prohibit the issue of stock dividends as well: "A stock dividend by corporations subject to our jurisdiction is not now permitted by law."¹¹

The laws of Wisconsin contain specific prohibition: "No public service corporation shall declare any stock or bond dividend, or divide the proceeds of the sale of any stock or bonds among its stockholders." That statute is qualified, however, in that it permits the issue of securities "for so increasing the total amount of its stocks, certificates of stock, bonds, notes, and other evidences of indebtedness, where such total is less than the value of its property, as found by the Commission, as to equal or more nearly equal such value." Securities thus issued would, of course, be distributed among the stockholders as special dividends, even without express permission, which is, nevertheless, granted: "Such new stocks, certificates of

¹¹ *Matter of Babylon Electric Light Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 135.

stock, bonds, notes, or other evidence of indebtedness, or any part thereof, or the proceeds or any part of the proceeds derived therefrom, may be distributed equally, share for share, among the holders of stock or certificates of stock of such corporation already issued."

A situation similar to the above will arise wherever the statutes, although silent as to dividends payable other than in cash, authorize the issue of securities to place the capitalization on a par with the physical value of the property; provisions to that effect were included in a federal bill proposed some years ago to vest in the Interstate Commerce Commission authority over the issue of securities by interstate commerce corporations.

On the other hand, the public utilities laws of a number of states expressly permit the declaration of stock dividends; among these are Maine, Missouri, and Ohio. The statute of the last named state reads: "No public utility or railroad shall declare any stock, bond, or scrip dividend or divide the proceeds of the value of any stock, bond or scrip among its stockholders, unless authorized by the Commission so to do."

Under provisions similar to this there have been a number of instances in which the distribution of stock dividends has been expressly authorized; for instance, the Ohio Commission authorized one of the corporations subject to its jurisdiction "to issue and distribute, pro rata, to the holders of its present outstanding capital stock, a stock dividend of the aggregate principal sum of Fifty Thousand Dollars . . . it appearing that said capital stock is to be issued and distributed among the holders of the present outstanding capital stock of the company in lieu of the surplus earnings thereof, which might otherwise have been distributed as dividends, but were expended in the construction of additions and extensions to its plant and property."

Where stock dividends are prohibited, an indirect method is sometimes used to accomplish the same end. The corpora-

tion declares dividends in the regular way, payable in cash; at the same time additional stock of an amount equal to the dividends declared is offered to the stockholders, who may purchase the shares by applying the amount of the dividend to the purchase price.

Case of the New York Central Railroad Company. The chief objection urged against the declaration of stock dividends is the supposed facility with which it can be made a device for stock-watering. The illustration which has become almost classical by repeated use is the declaration of a special dividend of 80 per cent by the New York Central Railroad Company in 1868. Following the declaration of the dividend, this company was consolidated into the New York Central and Hudson River Railroad Company, the special dividend distribution practically becoming an incident of the consolidation project as a whole. The merits or demerits of the transaction, therefore, should not be appraised without due consideration of all the incidents and in the light of the special circumstances or official acts by which they were supported or ratified. Reference to these can be found in the Special Acts of the New York Legislature authorizing or ratifying the various steps taken in the project, in the proceedings of the Hepburn Committee of Investigation, appointed in 1879, and in *Bailey v. Railroad Co.*, 89 U. S. (22 Wall.) 604.

The court decision above cited narrates the circumstances attending the declaration of the special dividend by the New York Central Railroad Company. The distribution of these dividends was not in the form of certificates of stock but of "interest certificates," carrying no voting rights, issued pursuant to the following resolution:

Whereas, This company has hitherto expended of its earnings for the purpose of constructing and equipping its road, and in the purchase of real estate and other properties, with a view to the increase of its traffic, moneys equal in amount

to 80 per cent of the capital stock of the company; and whereas, the several stockholders of the company are entitled to evidence of such expenditures, and to reimbursement of the same at some convenient period; now, therefore,

Resolved, That a certificate, signed by the president and treasurer of this company, be issued to the stockholders severally, declaring that such stockholder is entitled to 80 per cent of the amount of the capital stock held by him, payable ratably with the other certificates issued under this resolution, at the option of the company, out of its future earnings, with dividends thereon, at the same rates and times as dividends shall be paid on shares of the capital stock of the company, and that such certificates may be, at the option of the company, converted into stock of the company, whenever the company shall be authorized to increase its capital stock to an amount sufficient for such conversion.

The certificates were in this form:

**THE NEW YORK CENTRAL RAILROAD COMPANY
INTEREST CERTIFICATE**

No.....

Under a resolution of the board of directors of this company, passed December 19th, 1868, of which the above is a copy, the New York Central Railroad Company hereby certifies that A. B., being the holder of shares of the capital stock of said company, is entitled to dollars payable ratably with the other certificates issued under said resolution at the pleasure of the company out of its future earnings, with dividends thereon, at the same rates and times as dividends shall be paid upon the shares of the capital stock of said company.

This certificate may be transferred on the books of the company on the surrender of this certificate.

In witness whereof, the said company has caused this certificate to be signed by its president and treasurer, this 19th day of December, 1868.

The status of these certificates went before the United States Supreme Court for adjudication in order that the Internal Revenue Act of June 30, 1864, might be given effect in respect of the tax provided to be paid by "any railroad

company that may have declared any dividend in scrip or money due or payable to its stockholders, as part of the earnings, profits, income, or gains of such company carried to the account of any fund or used for construction," the rate of the tax being "5 per centum on the amount of all such dividends or profits." The New York Central Railroad Company had paid this tax under protest and sought to recover the amount thereof from the collector. The court declared these certificates to represent "*dividends in scrip*," reciting the facts of issue as follows:

"For years the . . . company had earned moneys greatly in excess of their current expenses without any satisfactory scheme being suggested to render such accumulating surplus available to their stockholders, as they were not authorized to increase their capital stock and were forbidden by law to make dividends for the benefit of the stockholders beyond ten per cent. Difficulties of the kind existing, the excess of earnings beyond current expenses had been expended in constructing and equipping their railroad and in the purchase of real estate and other properties with a view to the increase of their traffic.

"Accumulations of the kind had been appropriated in that way until the sum amounted in the aggregate to a sum equal to eighty per cent of the capital stock of the company. Dissatisfaction arose among the stockholders, and all admitted that they were entitled to evidence that the excess of the earnings of the company beyond the current expenses had been appropriated in that way, and to reimbursement of the same at some convenient future period.

"Motives, such as those recited, induced the company to grant the certificates . . . as evidence to the stockholders that an equal amount of the earnings of the company beyond current expenses had been expended for the objects stated in the preamble of the certificates. . . .

"These certificates are not dividends in money, nor are they stock or certificates of stock in the strict sense, but they

are exactly what they are described to be in the Revenue Act, to wit, dividends in scrip."

The resolution declaring the special dividend of the New York Central Railroad Company was adopted December 19, 1868, and on May 20, 1869, the New York State Legislature passed a law authorizing the increase of capital stock "to the amount of eighty per cent of its present capital," further providing that "the increase of capital stock authorized . . . shall be used only in exchanging the same for the interest certificates of said company authorized at their meeting held December 19, 1868." Also on May 20, 1869, the Legislature passed an act which authorized the consolidation of the New York Central Railroad and the Hudson River Railroad Companies.

The agreement of consolidation, filed with the Secretary of State November 1, 1869, authorized the issue of \$45,000,000 capital stock to be exchanged at par for \$28,795,000 stock of the New York Central (interest certificates not entering into this arrangement) and \$16,208,000 stock of the Hudson River Railroad Company. In addition, the agreement authorized the issue of "consolidation certificates" to be used "for the purpose of equalizing the values of the property of said Consolidating Companies, and making compensation to the stockholders of said Companies, respectively, for all differences in such values." The certificates were to "be payable ratably, at the pleasure of the Company, out of its future earnings," and it was further provided that "until the same be wholly paid off and redeemed, dividends upon the amount thereof shall be paid at the same rates and times, as dividends shall be paid upon the shares of the capital stock." The issue of these certificates was in the proportion of \$27 for each \$100 of New York Central stock, and \$85 for each \$100 of Hudson River stock.

Finally, the agreement also provided that the capital stock of the company "may at any time, at the option of the Board

of Directors of the consolidated Company, be increased to an amount sufficient to capitalize at par the interest certificates heretofore issued by the New York Central Railroad Company and the consolidation certificates authorized to be issued in pursuance of this agreement."

§ 75. Property Dividends

A property dividend consists of the delivery of property other than money, or the evidences thereof. It represents the distribution not of an amount of money or shares or bonds, but of actual physical property, or the stocks and bonds of another corporation. Because of the practical difficulties in the way of making equitable divisions of physical property, dividends of this kind are unusual. The form in which they most frequently occur is the distribution of securities held by the corporation either as investments or representing the consideration for which it has sold all or some part of its property. The securities distributed may represent either investments made by the company out of profits or the use of its capital funds. In the latter case, of course, the distribution would not be of "dividends" in the sense of dividing profits, but rather a device to return to the stockholder a part of his original investment. In this last phase the dividend may be an incident of liquidation and the entire capital of the corporation may be thus disposed of in such a case as the sale of the entire property of the liquidating corporation to another, the purchase price being received in securities of the purchasing corporation.

A good illustration of a property dividend is afforded by the declaration of an extra dividend by the Union Pacific Railroad Company January 8, 1914, which was payable to the holder of each share of common stock as follows: 12 per cent in Baltimore & Ohio Railroad Company preferred stock, 22½ per cent in Baltimore & Ohio common stock, and \$3 in cash. It has lately been proposed that dividends be paid in

"Liberty Bonds"; if carried out, this will constitute distribution of property dividends, since those bonds have not been made legal tender.

§ 76. Dates of Declaration and Payment of Dividends

Except in the case of guaranteed stocks, and sometimes of cumulative preferred stocks, it is not usual to have charter provisions or by-laws prescribe the intervals or dates at which dividends shall be declared or become payable. Leading corporations have adopted the custom of holding meetings of directors at regular intervals to take action on the declaration of dividends. These dates are well known and are anticipated on the stock market.

Dividends are payable to the stockholders of record, and in order that a correct list of these may be made, it is necessary, especially for the larger corporations whose shares are actively traded in, to fix an interval of one or more days during which no transfers can be recorded. This interval will immediately precede the date of dividend payments and the corporation upon announcing the declaration of dividends will also announce by letter or public advertisement the dates of closing and reopening of the stock transfer books. Stock sold in the interim is usually sold "dividend off," or "ex-dividend," meaning that the buyer is not entitled to the next dividend which will go to the transferor as the stockholder of record. The rules of the New York Stock Exchange provide that all cash sales of stock of a corporation, the closing of whose books has been announced, made on the day and up to the time officially designated for the closing of the books shall be made "dividend on," certificates being delivered on that same day rather than the following day, as is the usual custom, so that buyers may be able to get transfers recorded. All transactions on that day other than for cash, and all transactions in the interim while books remain closed, are made "ex-dividend."

Part III—Funded Debt

CHAPTER VIII

BONDS, TRUST DEEDS, AND MORTGAGES

§ 77. Corporate Borrowing

Modern financial organization has little place for the time-worn injunction: "Neither a borrower nor a lender be." Wealth increases only as it is utilized, and to a greater or less extent the rate of increase depends upon the amount of wealth put out for increase, although every business has its point of saturation beyond which additional capital will not produce as great a return as that before invested. Suppose a firm with a total capital of \$50,000 contributed by its members finds that it can double its earnings by doubling its capital, i.e., can use an additional \$50,000 in its business and earn 10 per cent thereon. It will do well, if this is the case, to borrow the additional capital. If it borrows \$50,000 at 6 per cent, the business will yield to the members of the firm a return of 14 per cent instead of 10 per cent on their contribution, while the contributors of the loan capital will receive their 6 per cent, presumably a fair return on their investment made under conditions of safety and other considerations of paramount importance to them. In this instance, the borrowing firm is "trading on the equity," a term which has been borrowed from England.

It is upon this principal of finance that the practice of borrowing capital for the purpose of developing and conducting corporate enterprises has become so well established. Concurrently with the extension of the practice of utilizing borrowed capital in corporate enterprises came an increase in

the amount of money ready for loan in the hands of bankers, insurance companies, savings banks, and similar institutions which had developed practical methods of bringing together and making available in large sums the small surplus capital of many persons. These financial corporations took a position intermediate between the owners of capital and those making use of that capital in productive enterprises. The necessity for these intermediaries has been twofold; first, they could offer more elements of security to their immediate capital-owning clients, and second, dealing with amounts larger than the individual capital owners could command, they could make more advantageous bargains both as to rate of interest and security of principal.

§ 78. "Loan Capital"

The total capital of a corporation which has traded on the equity consists of "share capital," representing the contributions of those who have invested their money primarily in the enterprise of the corporation, and "loan capital," representing the contributions of those who have invested primarily in a loan and only secondarily in the enterprise of the corporation.

Similarly to the authorization of share capital, authority for the acquisition of capital on loan must be found in the charter of the corporation. In this respect the rights and duties of the corporation need the clearest possible definition and regulation, for the integrity of "loan capital," in view of the limited and impersonal liability of the corporation, is more essential as a matter of public policy than that of the share capital. Authority for a corporation to borrow money and contract debts "when necessary for the transaction of its business, or for the exercise of its corporate rights, privileges, or franchises, or for other lawful purposes of its incorporation,"¹ is contained in general incorporation laws; it thus

¹ Quotation from New York statute.

becomes one of the incidental powers (distinguished from the specific powers to be enumerated in the certificate of incorporation) of every corporation.

A corporation has its legal residence in the state wherein incorporated, and the laws of that state control the exercise of the right to borrow. If certificates of indebtedness issued by the corporation are valid in that state, they are valid everywhere else. Corporations are often incorporated in more than one state; then, if the indebtedness is valid in any one state, it is valid in the others as well.

§ 79. Funded and Unfunded Debt

Debts incurred for the purpose of acquiring capital funds are usually for long periods, and the interest obligations become fixed charges against the income of the corporation for many years. Hence, such debt is variously termed "funded" or "permanent" debt. To distinguish between funded and unfunded debt is not always easy without some arbitrary rule. The rule which has found general acceptance classifies as "funded" all debt maturing more than one year after its creation, all other debt being classified as "unfunded." Here permanency is the only determining factor, and the line of division corresponds to that between fixed and floating capital. Under this rule, the instructions of the Public Service Commissions of New York classify as "unfunded debt" that which, though originally "funded," has since matured but remains outstanding; in other words, overdue funded debt, whether it remains overdue by agreement between the parties or inability of the borrower to meet payment, is to be classified as "unfunded." If the purpose of the rule is to afford some basis of apportioning the debt of the corporation between that presumably incurred for fixed capital purposes, and that incurred for floating capital purposes, the instructions do not appear to be logical, since the fact of maturity does not ipso facto work a change in the purpose for which the debt was

originally incurred. In theory, to be sure, the basis of the rule is strictly logical, for it is supposed that debt having a period of maturity will be provided for out of earnings during the life of the bonds, and that upon the maturity of the debt it ceases to represent fixed capital, its place being taken by the accumulated earnings which are to wipe out the debt. On the other hand, debt representing moneys borrowed to serve as loan capital is ordinarily intended to be permanent, and the fact of maturity is only an incident; upon maturity the certificates evidencing the debt may be changed but the debt itself will continue; no provision is therefore made actually to pay the amount of the debt, which is simply refunded. It would be rather anomalous to show instead of funded debt a large amount of unfunded debt at the particular instant when the old debt having matured is carried over, pending the actual refunding by a new issue.

This distinction between funded and unfunded debt has been carried into the public utility laws of all the states, regulation being practically confined to debt maturing more than one year from the date of its creation. The Public Service Commissions Law of New York requires the consent of the Commissions to the issue of "notes, or other evidences of indebtedness payable at periods of more than twelve months after the date thereof." But corporations "may issue notes, for proper corporate purposes and not in violation of any provision of this chapter or any other act, payable at periods of not more than twelve months, without such consent, but no such notes shall, in all or in part, directly or indirectly, be refunded, by any issue of stock or bonds, or by any evidence of indebtedness running for more than twelve months without the consent of the proper commission." This does not prohibit the renewing of such notes from year to year; the statutes of one or two other states, however, do prohibit the renewal of such obligations without the consent of the commission. Propositions have also been made to limit the

amount of unfunded debt which may be incurred without public authority to a certain percentage of the authorized funded debt.

§ 80. Corporate Bond Issues

Just as any individual may borrow money from a bank or from other persons on his notes, so also may the corporation. As a matter of fact, many corporations do borrow constantly from these sources to meet their current and temporary obligations, and the banking relationships of many large railroad and other corporations are very intimate and important; so much so that federal statutory regulation has been enacted. Many small and purely local corporations are practically limited to these sources in borrowing capital. This method, however, is not open to corporations contemplating an enterprise of some magnitude and expecting to borrow capital funds from a number of sources. Out of the attempt to borrow large amounts for long periods, and to interest a great many lenders, there has been evolved the system of corporate bond issues as it is now known.

The issue of capital stock, its par value, the nature and amount of consideration to be received therefor, the method of making valid subscriptions, etc., have been covered by statute ever since general incorporation laws were enacted, but the issue of bonds has not been similarly covered. Beyond the almost incidental reference to the fact that a corporation might borrow money "for the transaction of its business or for other lawful purposes of its incorporation," statutory regulations covering the issue of bonds have been almost wholly lacking, save for some general provisions that the aggregate amount of bonds should not exceed a given proportion of capital stock or property values. It has been only recently that a proper measure of restrictive and definitive regulation of corporate borrowing has been introduced. In the future these safeguards for the investor are likely to be much extended.

§ 81. Bonds and Notes

Money obligations are usually evidenced by instruments in writing—promissory notes, bills, etc. All such instruments come within the general term “bonds,” e.g., the bond accompanying a mortgage. When used in relation to corporate debts, however, the word “bond” has come to have a special meaning, denoting the evidence certifying a funded debt obligation, usually one of a series, each of the same par value, interest-bearing, with the principal of the debt payable at a time and under the conditions recited in the instrument. These bonds may be negotiable or non-negotiable. A negotiable bond is essentially a promissory note, but more elaborate in form and, in addition to the usual recital of a promissory note, contains special terms descriptive of the rights of debtor and creditor. Then there is a class of corporate funded debt designated “notes.” That term, so used, implies an obligation maturing within a comparatively short period, while bonds cover a longer period. As these short-term obligations are most usually unsecured by collateral or mortgage, an extension of the accepted meaning may bring within the term “notes” all unsecured notes or obligations, and within the meaning of “bonds” all secured funded debt obligations.

§ 82. Bonds and Stocks

A bond is a promise to pay a sum certain in money at a specified date; capital stock is a promise to divide corporate assets. The issue of a bond creates the relationship of debtor and creditor; the issue of capital stock adds to or further distributes proprietorship. A bond expresses a par value which is the measure of corporate liability; a share of stock expresses a par value which is merely nominal, indicating no liability save that of apportioning to it a share of the corporate assets, and it is more of an evidence of a sum of money received than it is of a sum of money to be paid. The bondholder receives interest, a payment for the use of money; the

stockholder receives dividends, a share of the profits earned and surplus assets. In actual practice, however, there are many cases where the distinction is not clear-cut and definite, where the bond resembles a share of stock and vice versa. For instance, there are bonds having no date of maturity, hence they are not definite promises to pay sums certain in money at specified dates. Their issue, therefore, does not create the relationship of debtor and creditor except as that relationship may be created by the happening of a contingency, such as the failure to pay interest. It may also happen that a bond, properly so called, draws no interest and is entitled to share only in the distribution of earning if such a distribution is possible. These issues rest on the border line.

§ 83. Par Value of Bonds²

Just as the total share capital is divided into small units, so is the loan capital, but usually not into as small units. Up to a short time ago the customary par value of bonds was \$1,000. There were some of \$500, but very few of less amount. There were many reasons for making the par value of a bond greater than that of a share of stock. In many issues a separate certificate must be executed for each bond, while a single certificate of stock may convey any number of shares. For this reason, placing the par value of bonds at a higher figure meant economy, not only in the original cost of preparing certificates but also in the handling of sales and the labor of interest payments.

A corporation which expects to find a ready market for its bonds among capitalists will still continue to place the par value of these bonds at \$500 or \$1,000, some going as high as \$5,000 and \$10,000. Of late years in an effort to increase the market for bonds and to interest in their purchase men of

² The author uses the term "par value" as relating to bonds in deference to the common usage; a more appropriate term, and one which is beginning now to be more generally used, is "face value." "Par value" is not used in connection with ordinary promissory notes, either in common or legal phraseology, and since the bond is only a form of promissory note there seems to be no good reason for a different terminology.

small means, "baby" bonds of \$100 par value have been introduced upon the market. In the view of many bankers and investment houses these bonds find a ready market and are said to be in demand. Their issue involves, of course, a greater expense to the corporation issuing them, but it may be that the increased expense is offset by a more advantageous price realized because of their easier marketability.

In the case of registered bonds, described in § 89, the par value is placed at \$1,000, \$5,000, or other multiples of \$1,000, and a single registered bond may be equivalent to a number of coupon bonds.

§ 84. Security for Funded Debt

Corporate borrowing on a large scale is possible since many persons would rather invest in a loan to the corporation than in its shares of stock, because they want certain assurances to surround their investment. The most important of these assurances is that of security—a guaranty that the investment will be protected, that principal and interest will be paid according to agreement. These assurances may be wholly intangible if the faith of the lender in the stability of the corporate enterprise and its integrity is so great as to assure him of security. A corporation which is engaged in a stable business, and has been in operation for a period sufficiently long to have acquired a reputation for soundness of condition and efficiency of management, can often borrow capital upon its credit alone. Because of its standing and the availability of sufficient assets to meet its obligations at any time, loans resting simply upon its corporate credit may be as safe as loans made under the best of conditions can be. But such loans are not spoken of as secured. Only such loans are secured as are supported by a lien upon property, real or personal, so that upon default the debt may be satisfied by the application of valuable property or proceeds derived from the sale thereof. Thus, funded debts are broadly divided into

secured and *unsecured*. Unsecured funded debt is the exception to the rule; it is possible only to companies of strong credit. The market for unsecured funded debt is very limited indeed, since many individuals and institutions, such as trustees, savings banks, insurance companies, etc., which control the greatest portion of money available for loan, are restricted by law to investments in secured funded debt.

The lien of a debt upon property of the debtor is created either by operation of law, e.g., mechanics' liens, etc., or by private contract. The contract may be one of mortgage or pledge, depending upon the nature of the property upon which the lien is imposed. A mortgage relates to security consisting of real property, or real and personal property mixed, or, if it is a chattel mortgage, to personal property alone; a pledge relates only to security consisting of personal property, and possession goes to the pledgee.

The distinction between a chattel mortgage and a pledge may be stated thus: A chattel mortgage transfers the title in the thing mortgaged to the mortgagee, with a condition that if the mortgagor performs the promise for the assurance of which the mortgage is given, the sale shall become void and the title reinvested in the mortgagor, who, in the meantime, retains possession. A pledge leaves the title of the pledgor undisturbed, but transfers possession to the pledgee subject to an agreement that the latter will surrender possession when the pledgor performs the promise intended to be assured by the making of the pledge.

§ 85. Mortgages and Deeds of Trust

A mortgage is a contract by which specific property is conveyed by way of pledge to secure the payment of a debt or the performance of some other act. In form it is an absolute conveyance of the property to which it relates, and transfers the legal title to the mortgagee until such time as the mortgagor may demand the reinvestiture of title in himself by

performing the act or paying the debt according to the terms of the agreement out of which the mortgage arose. In actual fact it is not an absolute conveyance of an estate or interest in the property covered, but simply a lien thereon. The mortgagor remains the actual owner and exercises all of the rights of ownership until default, when his rights may be foreclosed by judicial decree or by the express terms of the mortgage.

The debt which has been secured by mortgage is evidenced by a bond. The evidence of the debt and the security for the debt constitute the "bond and mortgage." The debt is the principal thing, the security is only an incident of the debt; thus there may be a bond without a mortgage, but there cannot be a mortgage without a bond. A mortgage may fail or be void without vitiating the indebtedness upon the bond, but if the bond should fail or be void, the mortgage will also fail. If the interest upon the debt, or any part of the principal, should remain unpaid after it is due, the creditor may exercise his claim upon the property and through proper proceedings have it applied to the satisfaction of his claim. In thus securing the property to himself or exercising his lien thereupon, he does not, however, surrender any part of his claim upon the bond against the debtor. If the proceeds of the sale of the property are insufficient to discharge the debt, the creditor may secure judgment against the debtor for the deficiency and have execution issued against any other property he may own.

The ordinary form of bond and mortgage, while adequate for transactions between individuals, is not adapted to a situation where there are a number of lenders and one borrower upon the security of one group of properties. It is impossible to execute an individual indenture of mortgage to each person; hence corporate mortgages are executed in favor of third parties, "trustees," who hold the property, i.e., the legal title, in trust for the securing of the obligations to be met, possession remaining in the mortgagor until defeasance. A corpor-

ate mortgage thus differs from the ordinary mortgage in that it not only effects the transfer of property for the securing of debts but is also an instrument creating a trust. It is therefore variously designated a "trust mortgage," "deed of trust," "trust deed," or "mortgage deed of trust."

The power to mortgage is closely related to the power to sell; hence a mortgage covering real property is governed by the laws of the state where the property is located and not where the company is incorporated. Such a mortgage is required to be recorded, usually in the office of the clerk of the county wherein the property is located. In the case of railroad corporations some states have special provisions which permit filing with the Secretary of State in lieu of filing in each county through which the road passes.

Railroads and public utilities are held not to possess the unrestricted right to mortgage their properties in the same way that individuals possess the right. The reason for this is that the exercise of creditors' rights to be thereby created may bring about foreclosure and sale of the property, interfering with operations and even causing their complete abandonment. Having accepted a franchise carrying a public duty, they must continue to administer that duty and cannot by their own volition resign therefrom or cause it to fail through any device whatever. Hence, although in dealing with the property the corporation will need to observe especially the laws of the state in which the property is located, the laws of the state of its incorporation will also be controlling by reason of their influence upon the general powers exercised by the corporation.

The deed of trust executed by a large public utility or railroad corporation is a very formidable document which sometimes runs into hundreds of printed pages. It is not the purpose of this book to go into detail as to the construction of a mortgage or deed of trust, and only its principal features are discussed herein.

§ 86. Parties to, and Authority for, Execution of Trust Deed

The parties to the deed of trust are the corporation executing it and the trustee. The bondholders are not a party to the agreement at all, but throughout the instrument the promises to pay are in favor of "the holder or the registered owner, as the case may be, of every bond issued and secured hereunder." Title is conveyed to the trustee "in trust, nevertheless, for the use, benefit and security of the Trust Company, as Trustee, for the equal and ratable use and benefit of all and every one of the persons, firms, or corporations, who, or which, shall become or be the holders of the bonds intended to be secured hereby."

The authority for the execution of the deed of trust is set forth at the beginning of the instrument. The resolution of the board of directors, describing the circumstances under which and the purposes for which the bonds are to be issued and the mortgage executed, is copied in full, followed by reference to the consent of stockholders duly given. Where the specific authorization of a state or governmental authority is also required, the fact that it has been procured is always stated.

§ 87. The Bond Agreement

The bond is an agreement complete in itself. When the corporation executes and issues a bond, it makes a definite promise to pay the amount of that particular bond in accordance with the terms expressed therein. In the case of unsecured bonds, each one would be complete in itself and subject to no limitation upon the bondholder's right to claim payment upon maturity. The same is true concerning the obligation upon a secured bond; the security of the latter, however, extends to the entire issue, and the conditions and the provisions of the mortgage limit the individual bondholder's right to resort to the security for the satisfaction of his claim. These also restrict the choice of the company to

pay some of the bonds without paying all others of like rank and maturity. These conditions and provisions are not set out in full in the text of the bond, but are incorporated in the agreement by specific reference to the mortgage or deed of trust in which they are to be found. In this way the bondholder is charged with knowledge of, and held to, all of these conditions and provisions. The bond agreement recites that: "This bond is one of a series, of like tenor and date, numbered consecutively from one upward, issued and to be issued under and in pursuant of, and all equally secured without priority or preference by a mortgage or deed of trust to the Trust Company. of New York, bearing even date herewith, of all the line of railroad of said Railroad Company now built or to be built, and the franchises authorizing the construction and operation thereof now owned or hereafter to be acquired, as therein set forth."

On the other hand, the bond agreement is set forth in the mortgage and becomes an inherent part of it, so that failure to perform, or improper performance of the several parts of the bond agreement, will entitle the trustee to proceed against the property which comprises the security. It is necessary that the bond agreement be incorporated in the mortgage, for no mortgage can exist without a bond, while, as already stated, a bond may exist without a mortgage.

The steps to be taken preliminary to the issue of the bonds to render them valid evidences of indebtedness or to bring them within the operation of the trust deed, the manner in which the conditions of the bond agreement shall be performed, the acts or omissions which will be deemed to constitute breaches of its covenants, and the rules which shall govern resort to the security for the satisfaction of the company's promises, are minutely described in the trust deed.

The promise to pay is divisible into two parts, the payment of principal and the payment of interest. The security for both is the same; so also the medium of payment, e.g., "in

gold coin." It is also usually provided that the principal and interest are "payable without any deduction for any tax or taxes which the company may be required to pay or to retain therefrom, under any present or future law of the United States, or of any State or County, or municipality thereof." The force and effect of these provisions are further discussed in § 104.

Permanent certificates, usually engraved, are designated as "definitive" bonds. Pending the preparation of these certificates temporary bonds may be issued. The recital and effect of the temporary certificates are substantially the same as those of the permanent bond, and they are signed, authenticated, and certified in like manner, but bear a notation that they are temporary certificates exchangeable for a like number of permanent bonds.

Ordinarily the mortgage specifies the aggregate amount of the bond issue to be put out; if it does not limit the issue to any specified amount, it is spoken of as an "open" mortgage. After the entire aggregate amount of the issue has been put out, the mortgage is "closed"; but if only a part has been put out, the remainder to be issued from time to time and as occasion may demand, the mortgage is "open-end."

§ 88. Parties to the Bond Agreement

As in every agreement which is to be complete in itself, the bond agreement must identify the parties thereto. The parties to this agreement are different from those to the mortgage or deed of trust. The latter is between the corporation and the trustee, with only collateral reference to the bondholder. The bond is an agreement between the corporation and the owner of the bond, with only collateral reference to the trustee.

The identity of the obligor is sufficiently indicated by the designations: "Know all men by these presents, That the Company, a corporation organized and existing under the laws of the State of New York, for value

received, promises to pay," etc. To be a valid instrument, however, the certificate must contain the signature of certain officers and bear the corporate seal. The signatures required are indicated in the witnessing clause of the bond, and are also covered by provisions in the deed of trust. The last clause of the bond recital will read: "In witness whereof, the Company has caused these presents to be signed by its President or one of its Vice-Presidents, and its corporate seal to be hereunto affixed, and to be attested by its Secretary or Treasurer or an Assistant Secretary or an Assistant Treasurer, all in the City of New York," etc. It is usually provided that the engraved fac-simile signature of the treasurer shall be sufficient certification of the interest warrants.

The definiteness with which the obligee or payee is described depends upon the form of the bond; if it is a coupon bond, the payee is not named at all, while if it is a registered bond, the payee is designated by name.

The trustee is not a party, but his certification upon the bond is very frequently required, in which case the bond recites: "This bond shall be valid only when authenticated by a certificate indorsed hereon, signed by the said Trust Company, Trustee under said mortgage or Deed of Trust." The certification is merely to the effect that "this is one of the bonds issued under the mortgage or trust deed bearing date of referred to therein."

§ 89. Coupon and Registered Bonds

Classified as to form, bonds are of two main classes: coupon bonds and registered bonds.

A *coupon bond* recites that the obligor "for value received, hereby promises to pay to bearer." The owner of the bond is not named at all, and title to the bond passes by delivery of the certificate. Each bond is evidenced by a separate certificate; each one is complete in itself and not divisible into parts for the purposes of transfer. The coupon bond has attached to it

what are in effect separate promissory notes representing the periodic interest accruals. As each interest date comes around, one of these coupons must be "clipped" and presented to the corporation or its designated fiscal agent for payment. These coupons are payable to bearer.

A *registered bond* recites that the obligor "for value received, hereby promises to pay or assigns, ... Thousand Dollars," etc. Thus, the bond identifies its owner by name, and record of that ownership is made on the books kept for that purpose at the office of the corporation or its fiscal agents. As interest becomes due, it is paid by check sent direct to the registered owners. It will be noted that a place is left for the filling in of the amount, so that a registered bond may be the equivalent in par value of any number of coupon bonds.

The title to registered bonds cannot be transferred without an assignment in writing. The purchaser of the bond must then present his bond, together with the assignment, at the transfer office of the issuing corporation. In respect to method of transfer, registered bonds are comparable to certificates of stock.

If the registered bond is indorsed in blank, it becomes payable to bearer, but the owner of the certificate last recorded remains the owner so far as the corporation is concerned and receives the interest.

Because some investors prefer registered bonds and others the coupon form, many corporations make the bonds interchangeable, that is, the corporation will issue either registered or coupon bonds, and upon the request of any bondholder will exchange his coupon bonds for registered, or vice versa. If convertible either way, at will, they are called *interchangeable bonds*. Where both registered and coupon bonds are issued, the forms of both are set forth in the deed of trust.

The registered bond is registered both as to principal and interest, that is to say, the obligation as to principal and inter-

est is recognized only in favor of the registered owner. A combination of registered and coupon features is made by some corporations in the issue of bonds registerable as to principal only, called *registered coupon bonds*. These are ordinary coupon bonds in form, but have blanks on the back where the name of the owner may be written in. The corporation provides for entering this name on the record books and the bonds become registered as to principal, but interest will continue to be collected by the presentation of coupons. The bond itself relates that the obligor "for value received, hereby promises to pay to the bearer, or, if registered, to the registered holder of the bond, one thousand dollars," etc., "and to pay interest on said principal amount from May, ..., at the rate of 5 per centum per annum, payable at on the first day of November and May in each year, upon presentation and surrender of the annexed coupon." Bonds registerable as to principal only may be converted into coupon bonds by indorsing as payable to bearer, and recording upon the company's books as bearer bonds.

Some corporations have devised a method of registering both the principal and the interest of coupon bonds, by providing that the coupons may be detached and left with the corporation or its fiscal agent, the bond itself to be held by the owner with his name indorsed thereupon, which will also be recorded on the company's books as that of the registered owner. While the corporation has issued only coupon bonds by this method, it has also registered both the principal and the interest of its coupon bonds. By indorsing the same bond as payable to bearer, and so entering it on the company's books and reattaching the sheets of unused coupons, the bond is retransformed into a coupon bond.

Bearer bonds are transferred by delivery from hand to hand without any writing, and can thus be subject to such considerations as govern all negotiable paper, provided, of course, the other elements of negotiability also exist; to wit,

that the bond is an unconditional promise for the payment of a specified sum of money, payable at a known or determinable date, and that the holder thereof has acquired it in good faith, before maturity, and without knowledge of any claim which would defeat or diminish recovery of the amount expressed thereupon.

Coupon bonds are generally preferable because of their comparative ease of transfer, while registered bonds are preferable for the safeguarding of the certificates as well as convenience in relieving the owner from the trouble of anticipating interest dates, clipping coupons and presenting them for collection. Persons who only occasionally purchase bonds, or purchase to hold them for long periods, will not attach great importance to the difficulties of transfer and will value more highly the other features of registered bonds. The real difficulties of transfer, however, are not always fully appreciated.

"Owners of registered bonds may find in the comparative difficulty of transfer a greater disadvantage than they anticipate. It may cause delay in selling, and especially such delay in getting the proceeds of a sale as to be embarrassing. A broker cannot safely sell until he is certain there will be no difficulty about effecting a transfer. The corporation's agent for registry, if competent, is bound to be extremely careful about his authority to transfer, and may cause long delay in effecting a delivery by insisting on better evidence than that first supplied him. Procuring a transfer in the case of settling an estate always causes considerable trouble. A dealer cannot safely register a bond in the name of the purchaser and send it forward with draft for collection. The registry fixes title, and legal situations unknown, perhaps, to the purchaser as well as to the dealer, may intervene to deprive the dealer of his lien. Very possibly before payment and delivery the purchaser may die. In that event a great deal of trouble and long delay may take place before the dealer can get paid." ³

³ W. H. Lyon: "Capitalization," page 192.

§ 90. Property Subject to Mortgage

A corporate mortgage executed to secure an issue of bonds almost always covers both real and personal property. It is not necessary to describe at length the distinction between these two classes of property. A satisfactory classification is often very difficult without the application of more or less arbitrary rules. The road, track, and buildings of a railroad are real estate; its rolling stock, and station and other equipment are personal property. There have been rulings, however, to the effect that the rolling stock constituted fixtures upon, and were thus included within real estate; similarly, while the buildings, stations, conductor lines, pipes, or conduits of an electrical or gas company constitute real estate, much of the machinery and plant constitute personal property.

A mortgage covering real property alone is a real estate mortgage; one covering personal property alone is a chattel mortgage. Mortgages on real property must be filed separately from those on personal property, and those covering both classes of property must be filed twice—once as a real estate mortgage and once as a chattel mortgage. These provisions have been generally amended, however, in respect of mortgages executed to secure an issue of bonds, so that if they cover both real and personal property they need be filed only once and are in all respects considered as mortgages upon realty only. The mortgage itself will provide that: "Any personal property or chattels above conveyed and transferred, or intended so to be, now held or hereafter acquired, shall be deemed real estate for all the purposes of this indenture, and shall be held and taken to be fixtures and appurtenances of the said railroad and part thereof, and are to be used, and in the case of a sale thereof are to be sold therewith and in the same manner and not separate therefrom, except as herein otherwise provided."

The mortgage may be a lien upon both tangible and intangible property. Part of the intangible property of every corporation consists of certain rights and franchises, the pos-

session of which is essential to the operation of its business. These rights and franchises should always be subjected to the lien of a mortgage covering the whole property of the corporation or any separately operated part thereof. This follows from the very nature of the protection intended to be afforded the bondholders. Upon default the bondholders can either seek to have the mortgaged properties sold or may take possession of and operate them. They must, therefore, be able to vest in purchaser or to acquire for themselves the rights and franchises under which the operations are required to be conducted. These rights and privileges are the property of the corporation and, unless alienated by the provisions of the mortgage concurrently with the other properties, they remain vested in the corporation. All mortgages include provisions extending the lien to "all and singly the franchises, rights, and privileges now or hereafter appurtenant to or used in connection with the lines of railway above mentioned, or any branch thereof." Or, more specifically, to "all corporate, municipal, and other franchises, rights, easements, or immunities now owned or which may hereafter be owned, held, or enjoyed by or in any manner conferred upon said company."

These franchises do not include the right to be a corporation, which right is the property of the members of the corporation; hence, although all of the property of the corporation may be taken from it under foreclosure of the mortgage, it will continue in existence as a corporation.

Other intangibles may be specifically subjected to the mortgage, such as "all licenses, patents, patent rights, and franchises now owned or used, or which may hereafter be owned or used, by said company."

The income of a company is not included in the mortgaged properties unless it is specifically declared to be so included. Sometimes the income is pledged to secure interest alone, as in the case of income bonds.

Mortgage May Cover Property Acquired Later. The

mortgage may and usually does cover both property owned by the corporation at the time when the mortgage is executed and that which may thereafter be acquired. As already noted, a mortgage is theoretically a conveyance of property, the immediate and present use and possession of which are reserved by the mortgagor. A conveyance cannot usually pass legal title to property which the grantor does not own but which he may subsequently acquire, so that "in the case of an individual, a general charge on all the property which he may subsequently acquire might well enough be held contrary to public policy and void, being in the nature of a mortgage of the person and reducing the individual to a state of virtual villeinage";⁴ but these considerations do not apply to corporations and it is now well established that conveyances by way of mortgage of after acquired property are effective in equity. Any other conclusion would substantially defeat the utility of a trust mortgage, since a lien securing an issue of millions of dollars in bonds would be practically worthless if it covered only property belonging to the company at the time of its creation, especially where the mortgage has been executed, as it so often is, immediately upon the incorporation of the company when it owns little or no property. The after-acquired property clause may, on the other hand, prove embarrassing to future financing for additional construction or new acquisitions of property, since it may cause the mortgage lien to attach without furnishing the means of acquiring the necessary capital. Where this condition obtains, it may become necessary to defeat or defer the lien of the mortgage by placing title of the additional property in a separate but controlled corporation, and then leasing the property from that company, or else to acquire title subject to prior liens.

§ 91. Security Value of Property Mortgaged

So far as it serves to secure pecuniary obligations, there is

⁴ Machen on Corporations, Vol. 2, page 1856.

a very marked distinction between the basis of a mortgage executed by an individual or a corporation engaged in a purely private enterprise, and that executed by a public service corporation.

Where mortgages are given to secure money lent to an individual or to a purely private corporation, the amount of the money lent bears some relation to the value of the property mortgaged. The lender of money looks to the value of the security offered and lends a greater or less proportion of that value according to the extent of the risk he is willing to assume; he does not, however, assume any of the risk of the enterprise of the borrower. He expects that whatever the fortune of the borrower may be, his claim will be protected by the mortgage, and should the borrower be unable to pay back the money at the time appointed, he will, by causing a sale of the property upon which his claim is made a lien, be able to have the same satisfied. This supposes a market in which the property subjected to the lien of the mortgage has a value independent of the enterprise of the owner and where it will find a ready sale.

The holder of bonds in a public service corporation, however, does not occupy a corresponding position of security because there are no open markets for the properties and no fixed values, and also because he is restricted by public policy in the exercise of his remedies. The greater part of the properties covered by a mortgage may consist of tracks of a railroad or of a street railroad, the conductor system of an electric company or a telephone company, the pipe line of a gas or water company, and other machinery and equipment peculiarly adapted to the operations of those companies and having but a nominal value for any other purpose. Apart from the operations, and considered as rails and ties, copper or iron wire, poles and fixtures, wrought iron or other pipe, machinery, and real estate, the value of these properties is almost negligible. Very little of the right-of-way of rail-

roads could be sold to neighboring farmers even at a nominal price, while an electric railroad will either not have any, or at best have but little right-of-way which it can resell, especially if operating wholly within city limits. Lands occupied by railroad stations and shops represent but a small part of their total investment. The rails, ties, pipes, etc., to say nothing of the machinery, would have but junk value, and often the cost of tearing them up or taking them down would not be covered by the salvage. Yet these properties could not be duplicated at an amount less or perhaps even equal to the total par value of the bonds they are mortgaged to secure.

There is no market in which such properties have any values assigned them. If offered for sale, the only way of realizing an amount even remotely approximating the original cost is to find purchasers who will continue the use of those properties in the operations to which they are adapted, so that the only substantial element of value adhering to those properties is the commercial success of the enterprise.

Suppose that the operation of a certain property in a given locality has demonstrated that such operations are not and cannot be made commercially successful; such, for instance, as a railroad built to carry ore from certain mines which have become exhausted, leaving the railroad without any traffic or the possibility of developing traffic. The operation of such a road will be promptly discontinued. If it is then sold to satisfy the claims of bondholders, the sale will have but little, if any, effect in reducing their loss, which will be almost as great as though their claims had not been secured at all. Indeed, had their claims been unsecured their loss might not have been as great, because they would have demanded and received a higher rate of interest to represent not only a fair return on the investment but an additional payment as well to discount the eventuality of loss.

On the other hand, if the operations of a company have proved a success commercially, the bondholder is amply

secured even if the original cost of the property was much less than the amount of bonds issued against it; for if the corporation through adverse circumstances goes into default, necessitating a sale of the properties, there will be others anxious to secure the property for a substantial consideration, or it may be to the advantage of the bondholders themselves to take over and operate the property.

Public policy demands that the operation of enterprises upon which the public is dependent shall not be discontinued. Railroads must continue to run, communities must continue to be supplied facilities for lighting, heating, communication, transportation, etc., hence courts have been reluctant to decree foreclosures of such enterprises for the satisfaction of debts unless there is reasonable assurance that they will pass into the control of those who will continue their uninterrupted and efficient operation. This policy not only restricts the market but limits the exercise of the remedies to which the bondholder is theoretically and under the strict terms of the mortgage entitled. This matter is further discussed in connection with foreclosures and reorganizations (see §§ 96, 97).

Because of the misconception that often arises as to the security of bond issues under a mortgage, some have recommended the English debenture bond as more correctly and clearly reflecting the nature of the security. These bonds are usually secured on the "undertaking," meaning the whole enterprise, the entire business of the company, so that the bondholder is put upon notice that he must look to the success of the enterprise for the assurance of his claim.

§ 92. Control, Actual and Contingent, of Bondholders

The essence of the bondholder's security is the continuance of operations sufficiently profitable to assure the regular payment of interest. It is to his advantage, therefore, to reinforce the lien upon the property by some measure of control over the corporate affairs and operations. Seldom are bondholders

granted direct or positive control over corporate affairs—that is the prerogative of the stockholders. They possess, nevertheless, a certain measure of control, the greater part of which is indirect, contingent, or negative—control by veto rather than command, as it were. The provisions of a mortgage, and the relation of the mortgaged property to other properties owned and operated by the debtor corporation, need to be very carefully examined in estimating the strength of the security offered.

For instance, where bonds are a first and direct lien upon the entire property of the company, or upon any distinct portion thereof which can be operated independently of the other portions, the chief security lies in the fact that upon default the bondholders would come into absolute control of the property. Bondholders always have this contingent control which may, upon default on the part of the stockholders, become actual. Since such an eventuality will involve considerable loss to stockholders, they will do their utmost to prevent it, and the exercise of caution thus imposed upon them serves to benefit the bondholder by providing a valuable check upon the misuse of revenues or extravagance in operation. On the other hand, when it becomes evident that operations will be unprofitable, the stockholders may seek to protect themselves against impending loss, and will be anxious to remain in control as long as it is possible to get anything out of the property. In the attempt they may sacrifice the future efficiency and value of the plant by neglecting maintenance, ignoring replacements, and curtailing all expenses until the property becomes so deficient that dividends cannot possibly be maintained. The bondholders will then discover that their capital has been exhausted and they have been remanded to a lien upon a worthless plant.

There may be provisions in the trust deed intended to prevent such a contingency as that described in the foregoing paragraph. It may be provided that a portion of earnings

shall be applied to the building up of maintenance and depreciation reserves until a predetermined sum is accumulated; or it may be provided that a certain proportion of the gross earnings shall be spent or reserved each and every year for maintenance to be charged to operating expense accounts. Provisions of this nature are perhaps most frequent in mortgages issued by reorganized companies. Where efficient state regulation obtains, all public service companies are subjected, as a matter of public policy, to requirements looking to the safeguarding of the security along the lines indicated by the above provisions of mortgages.

A mortgage may, and often does, contain restrictions upon the stockholders in their dealings with the property so as further to protect the bondholders. A common and effective provision is one limiting the outstanding capitalization, providing, for instance, that the outstanding debt shall not exceed a specified multiple of the gross earnings for the previous twelve months, or that no more than a certain proportion of the total amount shall be issued in each year. A provision such as the last is intended to assure the investors that the company will not, during a given period, throw more bonds on the market than can be advantageously absorbed. It is an attempt to uphold the market values of bonds by, first, avoiding the depreciating influence on market price of a new offer while a former issue remains not fully absorbed, and second, giving the corporation opportunity to realize upon the revenue-producing projects to which the proceeds of former issues have been applied so that its credit may be correspondingly strengthened and subsequent issues marketed to better advantage. These provisions, although valuable, are somewhat less important than they were before the advent of state regulation, for where the consent of a state commission is requisite to the issue of bonds, there is opportunity for full preliminary discussion of all matters pertaining to the expediency of the issue or the protection of other creditors. It is always well to

have the trust deed embody such provisions, however, for it gives the bondholders a certain measure of control independent of governmental commissions.

§ 93. Trustees

In selecting trustees under corporate mortgages, trust companies in financial centers are favored. Many advantages are claimed in the selection of these companies instead of individual persons. "They do not die; the large amount of financial business which they daily transact provides them with the machinery for such purposes; while their well-known names stand as evidence to the purchasing public that at least the necessary formalities have been complied with."

Trustees do not become guarantors of the bonds issued upon the security of the mortgage. Most of the large trust companies, however, recognize the fact that their position and influence impose upon them some measure of responsibility to safeguard the interests of the bondholders. In addition to the responsibility thus voluntarily assumed, a trustee becomes charged with certain definite responsibilities and becomes obligated to perform the duties outlined in the mortgage indenture. He represents the bondholders and stands in a fiduciary capacity; he must, therefore, deal with them in absolute good faith and he cannot have any interest in the property or in the debtor corporation which may even slightly conflict with the administration of the trust. When the acts of the trustee imperil the safety of the property under his control, and his continuance in office may prejudice the rights of the holder, he may be restrained by injunction and even removed by the court. The mortgage itself usually will provide a method for the removal of the trustee and the substitution of a successor.

It would not be altogether correct to characterize the trustee as an agent of the bondholders generally, for in certain instances he really occupies an independent position. In still

other instances his duties to both the corporation and its bondholders are coextensive; in some actions he is really the agent of the bondholders alone. In at least one situation he becomes an agent for the corporation itself, that is, where he is the custodian of securities pledged as collateral by the corporation. Should any of the companies whose securities are held by him be in default, he will be called upon by the pledgor corporation to institute the proceedings necessary for enforcing the mortgage or trust by which the pledged securities defaulted upon are secured.

In all litigation connected with the trust the trustee represents the bondholders. Bondholders can exercise their rights against the property only through the trustee, except in extraordinary cases where the trustee may refuse to institute the proper proceedings and a bondholder may take it upon himself to do so. If the trustee acts in good faith, whatever binds him in litigation instituted or other proceedings had under the deed of trust, binds the bondholders as well.

Mortgage provisions limiting the liability of the trustee for negligence in the administration of the trust are general, excusing him from taking any action unless indemnified against loss, etc. Just how extensively these provisions may absolve the trustee from responsibility is not altogether clear. It has been held that a stipulation exempting the trustee from any liability except for his own wilful and intentional breaches of trust excuses him from any responsibility for mere mistakes or misconception of his obligations. Trust companies designated as trustees are ordinarily very conscientious in the exercise of their obligations and not much litigation has resulted because of their malfeasance or misfeasance.

A trustee is bound to see to it that the mortgage is duly recorded, and if he should neglect to do so and a subsequent encumbrance should obtain priority, he may be held liable to the bondholders for the resulting loss. He should be particularly diligent in the protection and enforcement of the

security; for instance, where any large quantity of property is later to be acquired and brought within the lien of the mortgage, he should require satisfactory proof that those properties are not subject to encumbrances ranking prior to the lien of the mortgage.

Until the debtor corporation defaults, the duties of the trustee are mainly passive; but after default they become active, and he must take definite and appropriate action. His duties in this contingency are described in connection with the discussion of bondholders' remedies (see § 96).

§ 94. Certification of Bonds by Trustee

One of the most important duties imposed upon the trustee is that of certifying bonds for issue. Under practically all mortgages no bonds can be issued without the indorsement of the trustee upon each bond, certifying that the prescribed conditions of issue have been met. The exercise of this power, if not perfunctorily used, enables him to safeguard the interests of the bondholders through insistence upon strict performance of all the acts required by the mortgage to be performed as conditions precedent to the sale of the bonds. If the corporation could issue bonds without any restriction, or demand certification without adequately accounting for former issues, the mortgage might afford but little security. Since the conditions under which certification must be given are prescribed by the express provisions of the mortgage, trust companies which realize the responsibility of this function should demand that mortgages be so drawn as to place within their possession suitable data by which they may, before certification of additional bonds, satisfy themselves and the bondholders that the proceeds of previous issues have been legitimately applied to the purposes for which the money was advanced.

Adequate provisions for insuring the proper use of the proceeds of issues already placed are very essential. Take, for

instance, the situation of a company projecting the construction of a railroad and issuing bonds for the financing of the project. The bondholders do not have any considerable tangible security until the road is completely built and equipped. In the meantime, the sole assurance that they may have for the integrity of their investment is that the proceeds of the bonds issued have been properly expended in construction and for capital projects. Requirements for certification purport to extend this assurance to the bondholder, but whether they do so or not as a matter of fact will depend upon the conditions under which certification may be demanded of the trustee.

Merely limiting the amount to be issued during a given period may benefit the bondholders in other respects, but not very materially so far as the assurance that the proceeds of past issues have been properly expended is concerned. Affirmative proof of these facts should also be placed on record with the trustee, and the mere recital in the mortgage that the company will not spend the proceeds for other than proper purposes, is not very effective. Such a provision as the following, for instance, makes a certification a purely perfunctory act; "..... dollars of the face value of said bonds shall be *certified and delivered* to the Railroad Company, or upon its order, *on filing with the Trustees from time to time a copy of a resolution of the Board of Directors* of the Railroad Company, certified under its corporate seal by its Secretary or an Assistant Secretary, requesting such delivery. The Railroad Company covenants that none of such bonds or the proceeds thereof shall be used for the ordinary maintenance of the lines of railroad, ferries, and other property owned or controlled by the Railroad Company, or for any other expenditures which are ordinarily treated by railroad corporations as operating expenses."

Effective assurance is extended to bondholders by provisions, for instance, that after the first instalment of an

authorized issue has been delivered to the company, no more bonds shall be certified by the trustee except upon satisfactory proof that the proceeds of bonds theretofore certified "have been actually used, or actually appropriated and set aside for liability actually incurred" for the purposes originally contemplated, specifying the amounts applied to each one of those purposes. It is also provided that "the price paid or liability incurred for such construction, or for such acquisition, betterments, or improvements shall not be in excess of the fair value of such property or of such work, and that the bonds included in such certificate were sold, disposed of, or otherwise accounted for, at not less than their fair market value at the time of such sale, disposition, or accounting," together with other facts to show that the amounts enumerated contain no duplication of expenditures or liability included in any previous certification. Provisions as detailed as these impose a great degree of responsibility and work upon the trustee.

In a number of instances mortgages have provided that certificates of bonds shall be limited to a certain amount per mile. If the estimates of total cost have been carefully made and the amount of bonds fixed per mile is substantially below the total estimate, such provisions will practically amount to requirements that the remainder of the cost be paid out of the proceeds of stock issues or moneys from other sources, thus maintaining a margin of safety for the bondholder.

The trustee is not usually called upon to investigate the accuracy of reports made to him. His responsibility is limited to the certification of bonds in accordance with the provisions of the mortgage and which prescribe that "a certificate signed by the President or Vice-President of the Railroad Company, or by its Treasurer, as to any fact, matters, or conclusions appurtenant to the right to certify and deliver bonds, as aforesaid, shall, as regards the trustee, be conclusive evidence of such facts, matters, and conclusions and be full authority for the action of the Trustee in accordance therewith."

Where adequate public regulation prevails, the state commission, in authorizing the issue of securities, will specify the purposes to which the proceeds of the issue shall be applied, and it should prescribe such conditions and restrictions as will insure full compliance with the terms of its authorization. Otherwise, there might be presented to some a strong temptation, after having secured authority for the issue of securities sufficient to meet the cost of high grade construction, to cheapen the work so that a portion of the proceeds of the authorized issue might be made available for purposes not contemplated by the commission. Hence the New York (Second District) Public Service Commission in authorizing an electric railroad corporation to issue bonds "for the acquisition of property in the construction of its proposed double track railroad . . . and for the construction and completion of the said road and maintenance of service thereon, in accordance with the plans and specifications therefor submitted upon the application for this authorization," etc., specified: "The said bonds shall be issued from time to time in instalments of not more than \$1,000,000 each, and only upon the making and entry of an order subsequent and additional hereto authorizing such issue, upon proof . . . upon each application showing for what purposes the proceeds of said bonds are to be used in the construction and completion of the work for which they are hereby authorized and the disposition made of the proceeds of previous issues of stocks and bonds; . . . nor shall such bonds be authorized except upon such application it is shown that the work is progressing in conformity with the plans and specifications submitted by the company upon this application."

§ 95. Custody of Stocks and Bonds Pledged as Collateral

When the purpose of a bond issue is the purchase of the capital stock or bonds of other corporations, the trust deed will authorize an amount of bonds necessary for the purpose

to be certified upon the presentation to the trustee of the securities acquired. In such case the securities acquired become subject to the provisions of the deed and must be delivered to the trustee pursuant to the laws governing the making of a pledge.

It goes without saying that since the bonds issued impose a fixed charge for interest, the stocks or bonds acquired out of the proceeds should be such as will reimburse the purchasing corporation for the amount of the interest which it will have to pay. The reimbursement may be by direct interest or dividend payments but most often the acquisition of the stocks and bonds of another company is for the purpose of exercising control over that company to the end that its properties or operations may be made to contribute definitely to the success of the controlling company's operations. For instance, the railroad of the controlled corporation may be so operated as to assure its development and continuance as a feeder to the railroad of the controlling corporation. The considerations which should control the acquisition of stocks and bonds out of the proceeds of bond issues are discussed in succeeding chapters.

If securities of other corporations are pledged under a mortgage, the trustee may do whatever is necessary to secure the title of those securities, i.e., he may have the shares of stock transferred to his name as trustee, or he may have coupon bonds converted into registered and the registered bonds recorded in his name. He may also be called upon to take proper proceedings to maintain the integrity of those securities, and, if necessary, to exercise the majority control of the shares held by him to cause the renewing or extension of the corporate existence of companies whose charters are about to expire.

The exercise of voting rights and the disposition of income from the deposited securities are provided for in the trust deed, the usual arrangement being that, prior to default,

the pledgor corporation may vote the stock and receive dividends and interest accruing from the deposited securities. After default, the trustee will exercise voting rights upon the stock and receive the interest and dividends upon the deposited securities. In some few cases the arrangement is that the trustee shall collect the interest or dividends, and apply the necessary amount to the payment of interest upon the collateral bonds, and the remainder to a sinking fund.

Upon default on the part of the pledgor, the trustee forecloses the equity of the pledgor and may then realize upon the deposited securities in accordance with the decree of foreclosure. In lieu of instituting foreclosure proceedings, he may exercise remedies authorized in the trust deed and which permit him, among other remedies, to sell the securities upon the open market.

§ 96. Enforcement of Lien for the Satisfaction of Debt

Upon default of the debtor corporation in respect of any obligation upon the bond or any requirement of the mortgage, the right of the bondholders to exercise their claim against the property becomes actual.

The rights and remedies of the bondholders may be enforced immediately upon default in the payment of principal or of any instalment of principal, or of interest. They may also be enforced upon the commission or the omission of some act which violates a covenant of the mortgage, provided, however, that the mortgage does not contain stipulations postponing the time when, after default, the remedies may be exercised. It is customary to provide that these rights and remedies shall become active only if default in the payment of interest, or in the due performance or observance of any covenant or condition of the mortgage, shall have continued for six months after the payment fell due, or after written notice from the trustee, or a specified proportion of the bondholders, concerning the default in performance of mortgage

requirements. These provisions are designed to protect the corporation from any unfair advantage being taken of its mistakes, inadvertences, or temporary financial embarrassment. No period of grace is allowed for the payment of the principal or any instalment thereof.

The rights and remedies of bondholders are enforced, as already noted, by and through the trustee, who is the mortgagee. The method of procedure is sometimes left to his sole discretion, but more frequently the mortgage contains elaborate provisions concerning the right of bondholders to direct the action of the trustee, describing the proportion of bondholders who must unite in the demand upon the trustee, providing for indemnities to be tendered him, etc. If the trustee refuses to act in a proper case, any bondholder may proceed to enforce the rights and remedies provided by the mortgage or by general law, on behalf of himself and the other bondholders.

The mortgage provides two methods of proceeding against the property. First, the trustee may take possession of the mortgaged property and operate it until the money due has been paid or adequately provided for, and if necessary, he may sell the property and satisfy the claims out of the proceeds. Second, he may sell the mortgaged property at public auction without entering into possession or operating it. A mortgagee cannot exercise either of these remedies as a matter of right unless the mortgage gives the power. These remedies are seldom exercised because of the personal liabilities which would be incurred by the trustee in the course thereof.

The third remedy given to the mortgagee does not depend upon any provision of the mortgage but is a right exercised under the law of the realm. This is the remedy of foreclosure. Upon default, the mortgagee may apply to the court for a foreclosure of the mortgage. The court then takes jurisdiction over the mortgaged property and all the rights and claims of all parties in or to that property. It will take

actual possession of the property through the appointment of a receiver and do all things which are necessary to conserve the property pending adjudication. In a proper case the court will direct the receiver to continue the business of the defaulting corporation.

Trustees almost invariably resort to this remedy of foreclosure to escape the serious responsibilities which the exercise of either of the other methods would impose upon them.

During the foreclosure proceedings and at any time before sale, or while the trustee is in possession pursuant to the power given him by the mortgage, the debtor corporation may reassume control and possession of the property by satisfactorily discharging the obligations which had been defaulted upon. In ordinary foreclosure actions the mortgagor is given the right to redeem the property even after sale, but in corporate deeds of trust the mortgagor waives the protection of such laws.

The receiver acts for the court and incurs no personal liability in the course of the proper discharge of his duties, for he is then acting in an official capacity as the representative of the court. His situation differs widely from that of the trustee who takes possession under the provisions of the mortgage.

The decree of foreclosure states the amount found by the court to be due under the mortgage and orders the debtor to pay the sum within a specified period; at the same time it directs the sale of the property in case the debtor fails to make the payment as directed. The manner of sale, the time and place, etc., are set forth in the order. The court may direct the sale of the property in one parcel or in different parcels, with due consideration to the mortgage provisions and the nature of the property. It is quite usual for railroad mortgages to stipulate that the properties shall be sold as one parcel. The decree also directs the manner in which the proceeds of the sale shall be distributed. After the sale the final

decree is signed by the court, thus confirming all that has been done under its jurisdiction.

§ 97. Reorganization

Since public policy demands that the operation of railroads and other public utilities be constantly maintained, the courts hesitate to order foreclosure where it is apparent that strict enforcement of the mortgagee's remedies will endanger the public service. They have, therefore, encouraged every legitimate means which will assure the passage of control to those who will maintain that service. Not only is this a matter of interest to the public, but those who are seeking to enforce the claim are themselves vitally interested in finding a purchaser who will take over the properties with the intention of keeping them in the service in which they have already been placed. If such a purchaser cannot be found, the bondholders will get a very small part of the amount necessary to satisfy their claims, for the bulk of public utility properties will have only junk value when withdrawn from the service for which designed.

Thus the enforcement of the bondholders' claim against the property has come to represent, in most cases, corporate reorganization. The foreclosure may be decreed and the property sold, but all plans for the purchase of the property on behalf of those who have agreed to enter the reorganization will have been fully arranged for and ways and means provided. A substantial proportion of the bondholders acting together will cause the appointment of a committee and, by depositing their bonds with the committee or its designated depository, will delegate authority to it in the formulation of a reorganization plan and its enforcement. The property is then purchased on their behalf at the foreclosure sale, and reincorporation effected pursuant to the statutes (generally the same in all states) authorizing the purchasers at such sale to reorganize as a new corporation. The new corporation will start out

with a clean page and can enter upon such financing as is necessary to put the properties in operating condition and to launch the new enterprise. The property may, of course, have been sold subject to encumbrances, which the new corporation will be required to assume, but the equities which were cut off by the foreclosure and the burdens of which the property was freed may be large enough to allow new financing to a sufficient extent.

In many instances there are a multiplicity of equities and priorities of claim under many mortgages, each covering some essential part of the property. Manifestly, to order a foreclosure and sale on each mortgage separately would disrupt the railroad or utility to a hopeless extent; moreover, the legal proceedings might be so long-drawn-out as to exhaust all reasonable patience and to necessitate inordinate expense. Hence, reorganization is quite frequently a compromise between many groups of creditors; it is not unusual to include the stockholders as well. The bondholders in the old corporation are permitted to exchange their holdings for stock or bonds of the reorganized company, at par or in some other proportion, and either with or without some further payment in cash. The basis of exchange may be different for the several classes of bondholders, depending upon the original priorities of their claims or the relative importance of the property constituting the security.

CHAPTER IX

CLASSIFICATION OF BONDS

§ 98. Bond Characteristics

The function of a bond title is to express the salient characteristics of the bond to which it relates; a classification of bonds, therefore, consists very largely of definitions of titles which are currently used. To attempt a logical classification of existing bond issues is almost impossible. There are a number of issues which are called what they are not and were never intended to be. There are others so ingeniously designated that the name might express any one of a number of characteristics some of which the bonds may possess in part and some of which they may not possess at all. The classification of bonds which is attempted here is along general, broad lines. The purpose of the discussion is to bring out the distinct characteristics of bond issues and not to enumerate all existing bond titles.

Secured and Unsecured Bonds. The primary classification is that between secured and unsecured bonds. Secured bonds include all those issues which are supported by a lien on the property of the debtor, no matter how remote or contingent that lien may be.

Indication of Property Mortgaged. Secured bonds are classified into two main groups on the basis of the nature of the property mortgaged or pledged for their security; the first group includes all those which are secured by a lien on realty, and the second those secured by a lien on personalty. Subclassifications of these two groups indicate more specifically the kind of property mortgaged or pledged; for instance, bonds secured on realty may be designated as *divisional*, *extension*,

terminal bonds, etc., while bonds secured on personalty may be *collateral bonds* or *equipment obligations*.

Indication of Ranking Order of Liens. The order of mortgages imposing liens upon the property for the securing of bond issues is always indicated in the bond title, e.g., *first mortgage*, *prior lien*, *refunding mortgage*, etc. The last title, however, and others similar to it, such as *general mortgage* and *consolidated mortgage*, suggest rather than specifically indicate a ranking order; they give notice of underlying issues and prior liens which in time will be satisfied and discharged. These titles, in fact, indicate the purpose of issue much more than they indicate the ranking order of liens.

Indication of Purpose. The indication of the purpose for which bonds are issued is often expressed in bond titles, but since in many instances the purpose is the acquisition of a certain kind of property which will be subjected to the mortgage of the bonds, the title serves a dual purpose, to wit, that of expressing the purpose and also of indicating the property comprising the security. Instances of this kind of bonds are *purchased-line bonds*, *bridge bonds*, etc. Other cases where a purpose is expressed along with other characteristics of the issue are those of *refunding bonds*, *general mortgage bonds*, etc., above referred to. *Improvement bonds* also come within this class.

Indication of Terms or Method of Payment. In the matter of the specified term in years, bonds are classified as *long-term* or *short-term*, and also as *straight bonds* or *serial bonds*. Straight bonds are those where the entire issue matures at the end of a given number of years. Serial bonds are those which mature in series during a period of years. These characteristics are not expressed in terms in the bond title, but the term in years is expressed, and if they mature in series, that fact is usually indicated. Then, as to options concerning earlier payment, there are *redeemable*, *callable*, and *optional bonds*; *convertible bonds* also come within this class, expressing an

option on the part of the bondholder. Again, as to the mediums in which repayment is to be made, bonds are described as *gold bonds*, *legal tender bonds*, etc.

Reinforced Security. In relation to additional security, there are two important groups, i.e., *sinking fund bonds* and *guaranteed bonds*. Sinking fund bonds are those secured by a mortgage, one of the provisions of which is that the equity of the bondholders will be increased by the creation and maintenance of a sinking fund. Guaranteed bonds express reinforcement of the security by the assurance of a third party that the debt will be satisfied according to its terms.

§ 99. Mortgage Bonds Secured on Realty

The term "real estate mortgage" when forming part of a bond title simply indicates that real estate comprises the property mortgaged for the securing of the bonds, which is true of the principal issues of all public service corporations, although personalty is also included. If the term were to stand alone, it would express no very definite meaning concerning the characteristics of the bond, although it would be a very proper and complete title for bonds issued by real estate companies. There may be exceptional bond issues of public service corporations which also may be properly entitled *real estate mortgage bonds*, or *real estate bonds*—a synonymous term, but one which is oftentimes thought to suggest a more definite limitation of the property to realty alone.

Note, for instance, the funding and real estate gold 4½ per cents of 1950 of the Western Union Telegraph Company, secured by a first lien on all the company's real estate in the cities of New York and Chicago, together with all buildings, fixtures, and equipment thereon. Bonds of railroad companies secured by lien on non-carrier properties are frequently described as "real estate bonds," although the title carries no suggestion of the distinction between these properties and others owned by the company. *Land-grant* bonds

are really real estate bonds, secured by a mortgage on lands granted by the government and intended for sale to settlers, the proceeds constituting a fund to redeem the bonds.

"Mortgage bond" as part of a title sufficiently expresses the fact that the security consists of a lien on realty, or realty and personalty mixed.

Divisional bonds are secured by a mortgage on a distinct operating branch or division of a railroad, and issued either by the present debtor corporation or by a predecessor company. *Extension bonds* represent issues made for the purpose of constructing an extension of existing main or branch lines where the part newly built will not constitute a distinct operating division. *Purchased-line bonds* (not purchase money) represent issues for the purchase of a road already constructed. *Terminal bonds* which are the direct obligations of railroad companies themselves are secured by lien upon terminal properties. More often "terminal bonds" are the obligations of terminal companies organized in the interest of, and to be controlled by, a number of railroad corporations which will also guarantee the bonds. Terminal bonds include tracks and other railroad equipment in addition to lands and buildings; such inclusion does not affect the description of the bonds except that if the tracks are of any considerable length the bonds which are the obligations of a railroad company may be better described by "divisional" or some other term. Similar to terminal bonds are *ferry bonds*, *dock bonds*, *wharf bonds*, *bridge bonds*, etc. In all these cases the title of the bond expresses the purpose of issue and also indicates the property subjected to the lien of the mortgage. *Improvement bonds* also express a purpose of issue, but do not indicate the nature of the properties upon which bonds will be secured.

§ 100. Mortgage Bonds Secured on Personalty

The two best-known types of funded debt falling within this class are *Collateral bonds* and *Equipment obligations*.

The security consists wholly of personalty, although in the case of collateral bonds there may be superimposed, by the nature of the collateral, the security of a real estate mortgage.

1. *Collateral Bonds.* These are funded debt obligations secured by a pledge of securities owned by the pledgor. These securities may be those (a) of corporations subsidiary to and controlled by the pledgor, (b) of corporations wholly independent of the pledgor, or (c) of the pledgor itself.

In by far the greater number of instances the collateral consists of securities of subsidiary companies. These subsidiary companies are of two classes, those which once were independent of the present controlling company, and those which were organized with the specific purpose of being made such subsidiaries. The manner in which these relationships are created and the method of financing the purchase of securities are described in Chapter XVIII.

Stock ownership is a necessary requisite of control over another corporation, hence shares of stock are used most often as collateral. The bonds of subsidiary corporations are not ordinarily held for the purposes of control. There are some rare instances where it is desirable to reinforce the control derived from ownership of capital stock by a direct lien on the subsidiary company's property, but where bonds are pledged as collateral the fact most often is that the controlling corporation could issue its own bonds to better advantage than the bonds of the subsidiary. Suppose A corporation organizes B corporation for the purpose of building an extension into an adjoining state; if bankers will take \$5,000,000 thirty-year bonds of B corporation at only 85 per cent of par, but are willing to take the bonds of A corporation at 90, A corporation, by issuing its own bonds and pledging the bonds of B as collateral to its own issue, will save \$8,334 annually. Suppose that the bankers had also required the bonds of B corporation to bear 5 per cent interest while they were willing to take the bonds of A corporation at $4\frac{1}{2}$ per cent, the latter

by issuing its own bonds will save annually an additional \$25,000 in rentals to be paid or other deductions to be made from its income. The bonds of the subsidiary corporation thus pledged would be first mortgage bonds, that is, a first lien upon the road constructed by it, so that although the collateral bonds of A corporation represent only a pledge of securities, by virtue of the mortgage incidence of the collateral they are an indirect but nevertheless effective first mortgage lien on the road of the subsidiary corporation. Such issues are sometimes designated as *collateral mortgage bonds*.

Where the collateral consists of the securities of controlled or system corporations, the measure of safety can seldom be predicated upon the value of the collateral. The most important element of that security really lies in the credit and the reputation for good management of the company which issues the collateral bonds, for the reason that the same conditions which may affect the situation of the major corporation adversely are apt to affect the situation of the controlled corporation in like manner. Moreover, the management of the major corporation, if in actual operating control of the subsidiary, may so manipulate the accounts of the subsidiary as to maintain the apparent integrity of its own operations at the expense of the other.

The most noteworthy instance of pledging the securities of an independent company under a collateral trust is that furnished by the collateral trust distribution gold bonds, so called, of the Adams Express Company, issued as special dividends in 1898 and 1907. In some respects the title *collateral trust bonds* seems inapplicable to these securities for the securing of which the company has placed certain stocks and bonds of independent companies with the trustee. According to the company's statement, these securities are not mortgaged or pledged "but were transferred outright to the Trustee of said Collateral Trust Bonds. The respondent (Adams Express Company) has no equity of redemption"; moreover, the inter-

est at 4 per cent is not paid by the company "but by the Trustee out of the income of the securities which were transferred by trust deeds."¹

In ordinary cases, where securities of independent corporations are pledged, the collateral trust bonds are for short terms only, issued to meet a pressing money stringency—collateral trust notes, more properly so called. They are issued most often where a company needs temporary capital which it does not want to obtain from an issue of long-term bonds or from the sale of securities owned by it and which would probably suffer depreciation through forced sale, hence it borrows on short-term notes secured by collateral.

Naturally, it is not good policy for a corporation to pledge the specific securities of independent corporations, held for investment, under a mortgage covering a long period, thus estopping itself from the realization of profits in a rising market or of protecting itself from losses in a falling market, unless the right of substitution is expressly reserved, as it usually is. Where such right has been reserved, the pledgor may withdraw from the pledge any securities by substituting others of like value. The collateral trust distribution gold bonds of the Adams Express Company provide for substitution. Issues where this right of substitution is reserved are sometimes designated *convertible collateral trust bonds* (to be distinguished from *collateral trust convertible bonds*).

It is quite usual for a corporation to borrow money from a bank for temporary purposes and to deposit its own treasury bonds as collateral for the loan, and it is not unusual for a corporation even to issue collateral bonds or notes secured by the deposit or pledge of another issue of its own mortgage or other bonds. An expedient of this nature is resorted to where the need of capital is temporary so that it is better to avoid the issue of long-term securities, or it may be resorted to be-

¹Quotations from company's annual report to Public Service Commission, Second District, New York.

cause of the uncertain condition of the bond market where long-term bonds could not be sold readily without being subjected to heavy discounts.

2. *Equipment Obligations.* There is a class of funded debt, most common among railroad corporations but not unknown to other public utilities, generally termed "equipment obligations" because issued to raise capital to be applied to the purchase of equipment and secured by a lien on the equipment so purchased. Within this general term of "equipment obligations" are included *equipment bonds*, *car or equipment trust certificates*, and *car or equipment trust bonds*. The circumstances under which equipment obligations were first introduced have clothed this form of funded debt with a number of special characteristics, and are responsible for the form in which these obligations are issued.

In the early history of railroad finance long-term bonds were issued for the original construction, including the equipment. Equipment, however, depreciates much faster than the way and structures. As the equipment originally installed wore out, its replacement became necessary either from funds on hand, current earnings, or the proceeds of a new loan. Since no adequate amount had been withheld out of past earnings, because of defective administrative or accounting practice, and since the current earnings were insufficient, the necessary sums had to be borrowed. In addition to the replacement of equipment already mortgaged, increasing traffic and territorial expansion created new demands which had to be met and for which very inadequate provision had been made in the initial financing. There were practical difficulties in the way of borrowing more money either under the existing mortgages (which had covered the equipment requiring replacement) or under a separate mortgage. Out of the position in which the railroads thus found themselves, there was evolved a new method which served a twofold purpose—it enabled the companies to acquire rolling stock out of the proceeds of a new

loan made under conditions which deferred the lien of existing mortgages, thus permitting a first lien to be imposed upon the equipment to secure the new issue of bonds; at the same time, in view of the experience gained from the issue of long-term obligations covering short-lived property, it strengthened the security for the new loan by requiring compliance more or less automatically with the essentials of sound financial practice relating to moneys borrowed on such security, which is, that where rapidly depreciating property is subject to the lien of a mortgage, provision for the immediate or future retirement of a proportionate amount of the debt should be made concurrently with the exhaustion of the property mortgaged. This purpose may be effected by making the bonds redeemable serially or by providing a sinking fund. The former is the usual method adopted in connection with equipment obligations.

Serial maturities of equipment obligations are so arranged that the debt is discharged before the usefulness of the equipment ceases. There is thus a substantial and constantly increasing equity in the holder of the obligations still outstanding, through the gradual reduction of the debt following the initial payment which at the very outset represents an equity of from 10 to 25 per cent of the cost.

It might be said that through serial repayments the equipment pays for itself. This would be true if each maturing series were paid by the debtor corporation out of current earnings, the amount of the payment being charged to the income-deduction accounts. There is no impropriety, however, in applying to the payment of these maturities moneys derived from sources other than the current earnings; except that the proceeds of bonds which are secured by the mortgage the lien of which was to be deferred through the issue of the equipment obligations, should not be used for the payment of the maturing series.

(a) *Equipment Bonds.* These bonds represent direct in-

debtedness of a railroad or other public service corporation, incurred for the purchase of equipment which has been specifically subjected to a first lien to secure the bonds. To impose a first lien upon the equipment it is necessary to use some device which will effectively defer the attachment of the lien of existing mortgages.

This transaction very often takes the form of a conditional sale, i.e., the property is sold upon condition that the vendor shall retain the title until the property is fully paid for. A conditional sale is very similar in its nature to a chattel mortgage, but with this important distinction, that in a chattel mortgage the mortgagor must first acquire title to the chattel before he can subject it to a mortgage, while in a conditional sale the vendee does not acquire title at all until the payments are complete. It is because of this characteristic that the device of a conditional sale is of such great utility in equipment obligations. The issuers of such obligations usually have outstanding general mortgages, the lien of which would attach to newly acquired property the instant title passes to the vendee, in this case the obligor under the general mortgage. Through the device of a conditional sale the lien of the general mortgage does not attach to the equipment since the title thereto has not passed to the railroad company, so that the latter is free to incur new obligations for the securing of which it can pledge the equipment acquired.

Conditional sales have not always been favored in law; for a long time, in fact, they rested under the avowed condemnation of the law as defeating the claims of existing creditors. In Pennsylvania conditional sales are still regarded with disfavor by the law, but practically every other state has recognized them by statute.

Under equipment bonds, title to the equipment purchased with the proceeds is transferred to a trustee, who leases it to the operating corporation, the latter paying as rental under the lease an amount equalling the interest on the outstanding

bonds in addition to a sum sufficient to take up the maturing bonds of the series. As a matter of fact these payments are made direct to the bondholder, either by the corporation itself or through its fiscal agents, although very often the fiscal agent is the same person as the trustee. When the bonds are all retired, the trustee transfers title to the operating corporation.

(b) *Car or Equipment Trust Certificates.* Car trust certificates represent the original form of equipment obligations, arising out of the disfavor with which conditional sales were regarded and the difficulties which surrounded the execution of chattel mortgages, to wit, the requirement that such a mortgage should be recorded in every county where the property was held. As rolling stock is carried almost everywhere, the difficulty and cost of recording chattel mortgages made them wholly impracticable.

Car trust certificates do not represent the direct obligation of a railroad or other public service corporation, but rather an interest, much like that of a share of stock, in an unincorporated association which owns certain equipment purchased with the proceeds of the certificates and subject to a contract of resale to a railroad or other public service corporation. Possession and use of the equipment is transferred to the railroad company under a lease, by the terms of which the latter covenants to pay an annual rental of an amount equal to the interest or dividends upon the certificates of the association, as well as a specified proportion of the principal of the whole fund represented by the certificates; these sums are applied by the association to the retirement of the serially maturing certificates. The lease and title are then assigned to a trustee for the securing of the certificate holders. The lease thus assigned represents the immediate security for the certificates, but since it is provided that in default of payment or failure to perform any condition of the agreement the lease may be terminated and the trustee, as assignee, repossess himself of the equipment, the real security consists of the equipment itself.

The certificates recite that the holder is "entitled to one share of \$1,000 in the Railroad Equipment Trust, Series 2," and that dividends will be paid upon the certificates "as evidenced by the dividend warrants attached thereto." These dividend warrants are in form of bond coupons reading: "Due to the bearer \$22.50, being semiannual dividend on certificate No. payable only out of rentals under the lease referred to in the said certificate." The certificate itself and the dividend warrants are usually guaranteed by the railroad company. Originally the lease was supplemented by lease warrants which, under the guise of rental, actually represented the deferred payments of the interest. The lease warrants now are not generally used, the provisions of the lease agreement being considered sufficient.

(c) *Car or Equipment Trust Bonds.* Instead of certificates of participation, corresponding to stock, being issued by an association such as above described, certificates of indebtedness, or car trust bonds, may be issued. The basis of car trust bonds is substantially that of car trust certificates, but an additional step is introduced through a mortgage on the lease.

(d) *Enforcing the Lien of Equipment Obligations.* The provisions for securing the holders of equipment obligations are practically the same whether these obligations take the form of equipment bonds, car trust certificates, or car trust bonds.

The equipment must be kept in good order and repair and is to be numbered and marked for identification, bearing the names of the parties in interest, e.g., "Guaranty Trust Company of New York, owner and lessor; Buffalo, Rochester and Pittsburgh Railroad Company, lessee, Equipment Trust Series F." The cars may, of course, bear the name of the railroad company which operates them.

An annual inventory is to be furnished showing "the numbers and description of such as may have been destroyed and substituted by others, the numbers of those repaired during

the preceding year, the numbers of those at the day of such statement undergoing repair or in the shops for repair," and the railroad must allow inspection at its own expense at least once a year.

Should possession be taken upon default, the trustee "may either hold or lease or dispose of said railroad equipment or so much thereof as it may be necessary, in such manner, at public or private sale, for cash or upon credit, and as the trustee may deem most beneficial," and if the proceeds be insufficient, the deficiency may be recovered from the railroad company.

Since the railroad company expressly undertakes to maintain the number and condition of the equipment subject to the trust, it must make adequate provision for depreciation and for renewals and replacements of the property. For instance, if a car subject to the lien of the equipment obligations is destroyed, the obligation of the railroad company to replace that car is absolute, and it must be replaced free from any lien superior to that of the trust agreement under which the destroyed equipment rested. It is therefore more than desirable that the company should carry upon its books separate depreciation, replacement, and renewal accounts for this class of property. These accounts must be separately stated in all published reports.

Equipment represents the tools with which a railroad conducts its operations; foreclosure of liens, therefore, will be most carefully avoided. Consequently, payments on equipment obligations will often be promptly met even when other obligations of the company are in default. A compilation made by the Guaranty Trust Company and published under the title "Railway Equipment Obligations" contains a study of the history of various equipment obligations. It reviews the record of railway companies reorganized between 1888 and 1914, or in receivership on the date of publication, where these companies had outstanding equipment obligations. It shows that in almost every case principal and interest of equipment

obligations were paid in full or else the holders were offered an advantageous exchange of securities, while other securities, with a few exceptions, were reduced in rate or amount or both. The conclusion of the compilers is that "in practically every case of railway reorganizations the principal and interest of equipment obligations have been paid in full or the holders otherwise reimbursed without loss."

§ 101. Ranking Order of Liens

The ranking order of the lien of the mortgage is of the very essence of security. There may be a number of mortgages upon the same property, and the determination of their proper order according to the priority of lien may become very difficult. Often bond titles are amplified to suggest this order clearly, but sometimes it happens that these titles convey very different meanings to those who framed them than they do to others, the ambiguity of meaning being not always disingenuous. "Railroad debt construction is a mysterious and wonderful thing—much more wonderful than creditable. The precedence of bond issues is as delicate, debatable, and involved as precedence at a state dinner."¹ This statement is equally true of the debts of other classes of corporations. Careful examination is always necessary. As an illustration of the inconsistencies encountered may be cited the prior lien bonds, so called, of a certain railroad corporation which, according to the generally accepted significance of the terms, should impose a lien superior to those of first and other mortgages. As a matter of fact, they are subject to the priority of first, second, third, fourth, and fifth mortgages on the greater part of the road, and subject to other mortgages on portions of the road and other property.

Where the bond title is intended to indicate the ranking order of the lien, certain terms more or less definite should be used. The term *first mortgage* is self-explanatory; it repre-

¹ Lawrence Chamberlain: "The Principles of Bond Investment."

sents the first lien imposed by mortgage. As relating to the whole property of the corporation whose bonds it secures, however, the term is no guarantee of the precedence of the lien, for there may be divisional or subsidiary company liens attached to various parts of the line, each taking precedence over the first mortgage placed upon the properties as a whole. Where these conditions obtain, the first mortgage bonds will usually outlive the maturity of the underlying bonds so as to become eventually a first mortgage lien upon the entire property. The general character of issues so related is expressed in the terms *underlying bonds* as against *overlying bonds*, and *junior bonds* as against *senior bonds*. *First lien* is synonymous with "first mortgage," but it may properly indicate that it is really a first lien on the property it purports to cover, since there are no underlying liens. The terms *second mortgage*, *third mortgage*, etc., suggest their own interpretation and are in general subject to rules similar to those governing the examination of first mortgages. Obligations imposing a lien upon property superior to those of first or other mortgages are called *prior lien bonds*; these are not necessarily secured by mortgage. Receivers' certificates become prior lien bonds upon reorganization of the corporation, the priority arising out of operation of law. If prior lien bonds are secured by mortgage they arise from contract; hence, the consent of mortgage bondholders whose liens will become deferred thereby is necessarily required.

The priority of liens becomes a perplexing matter and places many substantial difficulties in the way of additional financing, where there are a number of outstanding bond issues of different characteristics. There is now a decided preference on the part of financiers and bankers for large bond issues of one class in place of many issues variously designated and more or less independent of each other, relating to separate parts of the property of the one corporation, or ranking differently as liens on the same property. If there is to be only one

bond issue, its lien must necessarily be that of a first mortgage on all of the property of the corporation. An old-established company, however, may already have a number of first mortgages on separate parts of its property, as well as other mortgages of junior lien; even a new corporation may be in a like situation by having assumed mortgage debts of purchased or merged companies. Manifestly under these circumstances the company cannot impose a new first lien applying alike to all of its properties without discharging all existing liens, and that it may not be able to do until the maturity of the bonds. It will, therefore, execute a *general mortgage* and will thereafter carry out all of its loan-capital financing through the issue of general mortgage bonds which will be put out in series. The lien of this general mortgage will rank first on all properties not already encumbered, and as to other properties it will be a junior lien subject to prior liens. A designation sometimes used is *general first mortgage bonds*, a term not very definite in meaning, but perhaps intended to describe a general mortgage which is a first lien on the major part of the company's property; in this sense *general and first mortgage* has been suggested as a better term. First general mortgage, sometimes used, is altogether meaningless, since there can be no second issue of a general mortgage. *Blanket mortgage* is an older term of like meaning as, and now superseded by, *general mortgage*.

General mortgages cover all property owned or later acquired, and are executed for amounts sufficiently large to meet all reasonably anticipated demands for additional capital or refunding operations. Specific provisions for the latter purpose are included in the mortgage, and very often bonds of the new issue of a sufficient amount to redeem the underlying bonds are placed in the hands of the trustee.

Consolidated mortgage bonds are those issued by a consolidated corporation and secured by mortgage upon the properties represented in the consolidation. If these properties

had been unencumbered theretofore, the new issue would be a *consolidated first mortgage*; that situation, however, will very seldom be found. Almost always the consolidating companies have had bond issues of their own outstanding, and the problem of the consolidated corporation is that of putting out a bond issue which will produce additional funds and also provide for the refunding of the outstanding issues; the purpose here becomes identical with that of refunding or general mortgage bonds, and the title may accordingly be *consolidated refunding* or *consolidated and general mortgage bonds*. Bonds secured by a first lien on some of the properties and a deferred lien on the others may be described as *first and consolidated mortgage*.

Unifying is a term used with much the same meaning as "refunding" in bond titles, and expresses the eventual retirement of all existing issues and their unification in one issue.

Issues, the most important purpose of which is to merge into one a number of other issues by either retiring them forthwith or providing for their future retirement, are described as *refunding bonds*. Naturally, where the refunding issue is to supersede other liens it will ultimately become the only mortgage lien, i.e., a first mortgage, hence the frequent combination of the two terms in bond titles. *First and refunding mortgage* indicates a mortgage which is an immediate and direct lien on only a part of the property mortgaged and a deferred lien on others. As encumbrances on the other portions are removed through refunding operations, the mortgage will become an immediate and direct lien on the portions cleared; thus the position of the issue improves as each outstanding issue is retired. *Refunding first mortgage bonds* should, and ordinarily will, relate to an issue refunding a first mortgage issue and may not imply at all the purpose of consolidating a number of issues; while *first refunding mortgage* will relate to the first mortgage, in point of time, executed to secure bonds to be used for refunding operations.

Bonds issued in full or part payment of real estate transferred to the company are termed *purchase money mortgage bonds*. These may be issued to the vendors of the property or to others who are deemed to be advancing the money for the purchase. A purchase money mortgage is a prior lien upon the property purchased, taking precedence over all other liens which would otherwise attach.

§ 102. Debts Unsecured by Mortgage or Pledge

Unsecured debts are those not reinforced by a lien upon the property. The description of "unsecured," however, is not to be understood as relating in any way to the stability or strength of the debt. In the general class of unsecured debts there will be found some of the strongest as well as some of the weakest obligations. The fact that a loan has been made without security is often evidence of unquestioned credit, but the circumstances under which it was made need to be known.

1. *Debentures, Plain and Income Bonds.* Unsecured debts include all the liabilities of the company on open accounts, acceptances, notes, etc. The reference here, however, is to the more formally acknowledged obligations and those coming within the term "funded debt." These are *debentures*, *plain bonds*, *corporation notes*, and *income bonds*.

Debentures is a term very loosely used, relating to all unsecured bond issues. The different meaning assigned to it throughout England sometimes causes confusion to the reader of financial literature. This different English meaning is described below. The term *plain bonds* is now very seldom used. *Corporation notes* are to be distinguished from ordinary commercial paper in that they represent a more formally evidenced obligation. The great number of unsecured short-term issues which came into general use after the 1907 panic and which are still plentiful, are of this class.

All of the above described unsecured bonds carry definite provisions as to interest payments, but upon default the bond-

holder has no lien which he can exercise and he may recover judgment only as any other general creditor might do. *Income bonds* differ from these issues in that interest provisions are indefinite; interest is payable up to a fixed maximum rate only if earned. They may earn the fixed rate, or only a fraction thereof, or nothing at all. Their claim for interest follows those of other classes of debt. They are a preferred claim on earnings in precedence of that of capital stock. Income bonds are sometimes secured by second mortgage or other junior lien, so that the term *debenture income* is sometimes used to describe unsecured issues.

Unsecured bonds are sometimes given contingent security by agreement that the debtor corporation shall not place any other mortgage upon its property, or that if one is placed the debentures shall be included in, and secured by, that mortgage equally and ratably. The equity existing at the time the bonds are issued and available to the general creditors is thus protected.

2. *Meaning of "Debenture" in the Financial Practice of England.* There is no warrant, in the meaning of the word itself, for the use of "debentures" as a generic title to describe all unsecured issues; in fact it can more properly be applied to all funded debt issues. This is the sense in which it is generally used in England where corporate debts are classified as to security into debenture bonds, simple debentures, and mortgage debentures. It will be worth while to describe these briefly.

Debenture bonds are unsecured and correspond to our plain bonds; they are mere promises to pay. In the case of *simple debentures*, to which incidental reference has been made in foregoing pages, the company charges its entire undertaking and all its property with the payment of the amounts secured by the debentures. In the event of default upon the interest, the principal matures and the charge upon the undertaking becomes enforceable through the appointment of a receiver.

The debenture holder may also intervene to obtain relief if the security is imperiled, even though the particular act which would make the principal repayable has not yet occurred. The floating charge of this class of bonds is its chief characteristic; it leaves the company unembarrassed and free to deal with its property in the ordinary course of business as if no charge existed—to sell, mortgage, or exchange the property as its necessities may require. The charge is dormant until by expiration of its life or the happening of an event causing maturity, the debenture becomes repayable.

Mortgage debentures are secured by a trust deed; they correspond to our usual mortgage bonds. Bonds of this class are frequently issued where the issue is of large amount; beyond the subjection of specific property to the lien of the debt (which may or may not be an added advantage over simple debentures), the chief advantage of these bonds is to be found in the fact that the agreement organizes the bondholders, provides the machinery for bondholders' meetings, and empowers a majority of, say, two-thirds or three-fourths in number and value of holdings at such meetings to bind the other bondholders to any promise or arrangement made by them with the corporation.

Debentures are *registered* or *to bearer* (corresponding to coupon bonds). In respect of maturity they are terminable or perpetual. They may be redeemable or irredeemable. These characteristics of bonds are discussed in a succeeding chapter.

Debenture stock has the same relation to borrowed capital as "stock" has to "shares" in English usage. (See § 59.) It represents the consolidation into one aggregate sum of all the capital borrowed on each issue, and each lender, instead of having a number of separate bonds, is thereafter given one certificate evidencing the corporate debt for the full amount due him; he may then transfer any part of the debenture stock in amounts of one pound or multiples thereof. The Commercial Cable Company on January 1, 1897, executed a mortgage

deed of trust to the Farmers Loan and Trust Company of New York, trustee, securing an issue of \$20,000,000 par value of 500-year 4 per cent first mortgage bonds, convertible at option of holders into "English Sterling obligations to be known as debenture stock"; with like term in years and similar interest provisions. The principal and interest of the stock were described as being secured by the same deed of trust, with like remedies upon default; the trust deed further recited that "the aggregate amount of said debenture stocks constitutes and is hereby declared to be a funded debt of the said Cable Company, duly acknowledged to each debenture stockholder to the extent of his holding."

3. *Receiver's Certificates.* These certificates are evidences of debt issued by the authority of a court and by a receiver in charge of the properties of a corporation. During receivership they necessarily are prior claims against the assets in the receiver's hands. If not discharged during the receivership, they are assumed by the company to whom the receiver surrenders the property and they become a first lien, ranking ahead of first and other mortgage liens.

Receiver's certificates are usually issued for short periods. They are issued to raise sums of money necessary for the use of the receiver in continuing operations and to meet current debts, complete inconsiderable portions of road or plant, etc. From the circumstances attending the borrowing of money by a receiver, at a time when the success of the enterprise itself is in doubt, and the credit of the corporation is nil, it becomes necessary to back up with exceptional security the loans made to a receiver, hence the priority of lien attaching to these certificates.

Technically, receiver's certificates are unsecured, but the effect given to them is such that they become very strongly secured, so far as it is intended by that term to indicate the degree of assurance that they will be paid when due. They usually meet with ready acceptance.

§ 103. Reinforced Security

One method of reinforcing the security of bond issues is by means of sinking funds. The principles of the method and its operation are related to other incidents of bond financing and are discussed in a succeeding chapter. (See Chapter XI.) Bonds so reinforced in security are called *sinking fund bonds*.

Another method of reinforcing the security of bonds is by an agreement of guaranty made by a third party, assuring performance by the debtor of its obligation to pay the principal of the bond, or the interest, or both principal and interest. These are *guaranteed bonds*. While the primary liability of the debtor corporation will usually be secured by a lien upon its property, the reinforcement of the obligation through the secondary liability of the guarantor is not secured by any lien upon the property of the guarantor. In dealing with guaranteed bonds, the circumstances out of which the guaranty arose must be carefully examined in connection with the contract of guaranty, in order to form an estimate of the degree of assurance afforded. There have been a number of instances where contracts of guaranty have been successfully repudiated.

The terms of the guaranty may be in a separate agreement or else indicated upon the guaranteed bonds themselves. After bonds have once been issued, they have sometimes been called for presentation and the name of a holding or other interested company has been indorsed thereon. A guaranty is implied from the presence of the indorsement and may be enforced against its indorser very much as in the case of any other indorsed note. These are called *indorsed bonds*.

§ 104. Taxation of Bonds

Bonds constitute personal property and they are therefore subject to taxation as such unless specifically exempted or separately taxed. The bonds represent a loan passing from the bondholders to the bond debtor; the proceeds of this loan are applied by the borrower to the acquisition of property to be

used in its business. If, then, the property in the hands of the borrower is taxed, it would seem as if the ones who made the acquisition of that property possible should not in turn be taxed. Nevertheless, the ownership of bonds has been so often thought of as a prerogative of the rich man, that the taxation of bonds has been popular as a measure of taxing the rich, while, as a matter of fact, it taxes the poor just as much. In a few of the states bonds are free from taxation if the property mortgaged is taxed within the state; other states make them tax-exempt after an initial recording tax is paid; most of the states levy annual taxes. Here, as in most other cases, taxes are imposed unscientifically and with little equity.

Where an annual tax is levied it applies to the principal of the bonds; the rate is usually expressed in a small percentage which, by comparison with the principal of the bond, makes the amount of the tax seem almost insignificant. The bondholder, however, compares the amount of the tax with the amount of interest which he receives upon the bond and he realizes how serious and burdensome the tax is; hence, he will not hesitate to take advantage of any opportunity to evade or avoid the payment of the tax. In fact, many persons who are absolutely honest and thoroughly scrupulous in their dealings with their fellows will not consider the evasion of this tax as a moral wrong, but will justify their act as the attempted correction of a moral wrong which would be perpetrated if the tax were actually collected. A tax of \$15 per \$1,000 of the principal of bonds may not seem to be unreasonable, but if the bonds taxed at that rate yield only 5 per cent per annum to the bondholder, the tax is equal to a levy of 30 per cent upon the income derived from the investment. "Which, then," inquires a leading writer on bond investments, "is more iniquitous, the imposition of this tax or its evasion? For, let it be remembered that the tax on bonds is seldom paid except by those who can least afford to pay: the beneficiaries from invested funds. The evasion or oversight of a mortgage tax is

difficult because of the general practice of recording real estate mortgages." ³

It has become the ordinary practice to exempt governmental and municipal bonds from taxation, presumably upon the theory that public agencies should be given an advantage over private borrowers in competing for capital, and be enabled to borrow at a lower cost than the others, which they are able to do because the investor will demand a higher interest from other borrowers if he knows that he must pay out part of that interest income as a tax upon his bondholdings. A very potent reason for giving municipal bonds this advantage has in some places been the fact that it was necessary to offer an inducement to attract again the capital which had been turned away because of the unscrupulousness of some municipalities in repudiating their obligations.

The first Liberty Loan of 1917 was entirely tax-exempt, while the second Liberty Loan was subject to super taxes only, outside of inheritance taxes. The interest on these issues was $3\frac{1}{2}$ and 4 per cent, but if other issues are put out in the future at higher rates of interest, made similarly tax-exempt, the result upon corporate borrowing will be that in order to overcome the advantage given to governmental borrowings private borrowers will need to pay substantially higher rates of interest.

A tax upon the income from the bond is unquestionably the most equitable method if bonds must be taxed annually; but the exaction of both income taxes and taxes upon the principal makes the burden of taxation unfair.

The trust deeds and bonds recite that the sum due on the bond shall be paid by the company "without deduction from principal or interest on account of any taxes, assessments, or other governmental charges which the Company may be requested to pay thereon, or authorized to retain therefrom, by virtue of any present or future law whatsoever." This frees the bondholder only from liability on taxes which are

³ Lawrence Chamberlain: "The Principles of Bond Investment."

directed at the corporation itself, and which are levied upon its realty, personalty, gross earnings, organization taxes, etc. The enactment of the Income Tax Law brought out considerable misapprehension of the nature and extent of the exemption above referred to. So many bondholders had thought the exemption would cover taxes upon the income accruing from the bonds, that a number of leading and representative corporations announced their determination to pay the income tax for their bondholders rather than attempt to avail themselves of the full extent of the limitation of liability to which they were entitled under the above clause. This, of course, was and continues to be a purely voluntary grant on the part of the corporations and does not modify the legal effect of provisions such as that quoted.

CHAPTER X

BOND INTEREST AND NET YIELD

§ 105. Interest

Interest is a payment for the use of money. Its payment implies the existence of a fund, owned by the one who receives the interest, loaned to and placed in the possession and for the use of another who pays the interest.

The payment of interest, therefore, represents a division of the return from the use of wealth. The income derived from that use is divided between the one who pays the interest and the one who receives it. The former borrows believing that the income over and above the proportion paid by him in the form of interest will represent a profit; the latter lends believing that in this way he can get the most out of his wealth without the risk involved in his own use of it; but it is the one amount of wealth which produces a profit to the one and interest to the other.

The buyer of capital stock expects that through his investment he will secure a profit (either in the periodic payment of dividends or in the increasing value of the shares themselves) at a rate somewhat approximating that which he would earn if the enterprise were his own individual business. Thus he becomes a partner in the business; his investment is an investment in the enterprise and the amount of his profit or loss will depend upon the success or non-success of the enterprise. He stands to win or to lose. This is not the case with the bondholder, at least not to the same extent. He also contributes to the capital of the corporation, but his contribution is a loan and is not charged with the entire risk of the business. His contribution is to be returned to him whether the business is

successful or not. The only risk which he is willing to assume is the ordinary risk which every man takes in making a loan. In consideration of being relieved of the risk, which will be shifted to the stockholder, the bondholder agrees to take a smaller proportion of the income accruing upon the capital of the corporation. The rate of interest is, therefore, determined largely by considerations of proportion of risk of the corporate enterprise of which the bondholder is relieved—the rate is lower as the security is greater. The greater security may be due to the value of the property mortgaged to protect the investment, as already noted, or the stockholders may have assumed a degree of risk so great as to leave the loan capital comparatively free from any risk. This latter situation is further explained in the chapter dealing with the proportion between capital stock and funded debt in the total capitalization. (See Chapter XII.)

§ 106. Payment of Bond Interest

Interest is ordinarily paid semiannually. In standard bond tables a semiannual payment of interest is assumed. Thus the interest dates will be the first days (sometimes the fifteenth) of January and July, February and August, March and September, April and October, May and November, June and December. In financial literature these methods are designated by the first initials, e.g., J and D. The choice of months is sometimes a matter of importance. The bulk of interest and dividend payments is now made in January and July, hence there is always a heavy demand on the money market for funds with which to make these payments, placing the corporation at some disadvantage if it has to borrow the actual money. On the other hand, because of the fact that on these dates much larger amounts of dividends and interest are paid out than at any other time in the year, considerable sums are released for reinvestment and new issues of securities are often timed so as to take advantage of this situation. It therefore

becomes desirable from the standpoint of the investor that he own securities with interest dates approximating these so as to be in a position to reinvest his income upon the most advantageous terms; of course, where he does not expect to reinvest the income, this consideration is not a factor. In fact, where the income from bond investments is depended upon to meet the current expenses of the investor, it will be to his advantage to select bonds with diversified interest dates so that his income may be distributed more uniformly throughout the year.

The bond itself recites the place where the principal and the interest are to become payable. Principal and interest are not necessarily payable at one and the same place. A bond is said to be domiciled at the place where the principal is payable. Some of the corporations which have large bond issues maintain their own fiscal offices where the bonds are domiciled and where interest is paid. Some issues are domiciled at a banking institution other than the office of the trustee. Many of the large corporations have the bonds domiciled in more than one place, both as to principal and interest, such as New York and Chicago for the accommodation of investors in the east and west, or New York, London, and Paris if the securities are to be placed upon all the markets centering at these points. In the case of bonds payable in various countries the language of the bond must, of course, be adapted to the currency of those countries. For instance, "One thousand dollars in gold coin of the United States of America of or equal to the present standard of weight and fineness, ... at its office or agency in the City of New York; or, at the option of the holder, in London, England, 205 pounds, 15 sh. 2d. Sterling; or if it were in Amsterdam, Holland, 2480 guilders; or, 5160 francs if paid in France, Belgium, or Switzerland; and to pay interest on said principal amount from May 1, 1907, in said cities and countries respectively, in said respective currencies, at the rate of per annum."

§ 107. Nominal Interest Rate

The rate of interest is stated in the bond and usually in the trust mortgage. But where the mortgage is for a large sum and contemplates future issues possibly at intervals of a great many years, the rate of interest will not be stated in the trust mortgage but will be left for the determination of the directors at the time when bonds are actually issued. This is true because the market conditions may change between issues and it is desirable to leave the directors free to make the best possible bargain at the time of each issue. On the open bond market it is not unusual to find two or more issues of the same class and kind of bonds, each bearing a different interest rate.

The rate of interest stated in the bond should be and is determined by the prevailing rate of interest upon loans made under like conditions. Interest rates rise and fall through competition for capital. The prevailing market rate must be approximated by the rate specified upon the average bond. Exceptional bonds, strongly secured, issued by a company of unquestioned credit, engaged in a well-established and growing business, may be issued at a lower rate. Bonds with the ordinary security and average credit will be issued at the prevailing or a higher rate, the rate increasing in proportion to the newness of the enterprise or the presence of other features introducing risk. At the present time there are a few old issues of bonds bearing interest at $3\frac{1}{2}$ per cent. Issues of this sort are comparatively rare among public service corporations, other than railroads, whose bonds until recently were supposed to be semi-speculative. There are a great many issues at 4, 5, and 6 per cent, together with the fractions of one-half in between. If all issues now outstanding are considered, the most usual rates will be found to be $4\frac{1}{2}$ and 5 per cent, while among the issues of the last few years 6 per cent has been a common rate. There are a few issues carrying 7 per cent interest. Such a high interest rate, if borne by a number of the issues put out

during a certain period, will reflect strong competition; but if it is found in comparatively few instances, it reflects the considerable amount of risk which the bondholders will be called upon to assume. An investor who is willing to assume that degree of risk will probably prefer to invest in shares of stock which present a greater opportunity for speculative profit.

The foregoing remarks relate wholly to the stated interest rate, which is called the *nominal rate* since it is the rate applied to the par value of the bonds; but the bond itself may be sold above or below par, making the actual interest income to the stockholders, i.e., the *effective rate*, depend not upon the par value but upon the amount paid, and may be greater or less, according to the discount or premium paid upon purchase.

It may be noted in passing that usury laws do not ordinarily apply to corporations. It is not usual to have statutory enactments as to interest rates upon corporation bonds. A proposed federal bill contained a provision limiting interest to 6 per cent per annum. It goes without saying that legislation concerning the nominal interest rate alone is ineffective and meaningless. It is the effective interest rate which must be regulated, but this is so much the product of competition and the relation between supply and demand of capital, that its regulation by arbitrary authority seems a questionable undertaking.

§ 108. Effective Interest Rate

The effective interest rate is the ratio of the amount paid periodically for the use of money to the principal sum actually received by the payer of the interest. It is thus to be distinguished from the nominal interest, which is a certain per cent upon the face value of a money obligation, even though the sum actually advanced upon that obligation was less or more than the face value therein expressed. It is also to be distinguished from the ratio of the amount received as interest by the holder of the obligation to the amount paid by him for

the acquisition of that claim, this ratio being usually designated *net rate of income*. The interest paid by the corporation and the interest income received by the bondholder will be the same amount only if the latter has received his bond direct from the corporation. They will not agree if the bondholder has come into possession of his bonds through another, save in the unusual circumstance of the original holder's having sold at a price exactly equaling the cost to him.

In ordinary commercial transactions, a note is discounted when the interest upon the same is deducted by the lender from the amount loaned, that is, the borrower pays the interest in advance. The difference between the face of the note which the borrower gives and the amount of money which he actually receives is the discount.¹ Ordinarily notes which are discounted are for very short terms and the discount retained by the lender represents all the interest which the borrower will pay on that one note. If, however, the lender retains a discount while the borrower is still obligated to make further payments for interest at rates and upon conditions stated in the note, then the amount of actual interest paid by the borrower is the discount suffered plus the amounts paid as interest.

§ 109. Issue of Bonds at Discount or Premium

Similarly, a corporation may discount its bonds. It can offer to accept an amount less than the par value, although it will be obligated to pay par upon maturity. The discount will represent an advance payment for the use of money, and since the bonds are currently interest-bearing, to the nominal interest rate must be added the rate prepaid by discount, and the result will be the effective interest rate.

There may be a number of conditions warranting the issue

¹ There is a slight difference between discount and interest at the same rate. The discount on a note for \$1,000 discounted for sixty days at 6 per cent is \$10, and the one discounting the note receives \$990. This is the ordinary bank discount. The interest at 6 per cent on a loan of \$990 for sixty days would have been only \$9.90, however—ten cents less than the amount of the discount. In bond issues where large amounts are involved, the true discount should be computed in order to have it correspond with interest accruals.

of bonds at a discount. The prospective purchaser may consider himself entitled to a greater than the nominal rate of interest, either because of the terms and conditions of the bonds or because of the risk of the enterprise. He takes that extra interest by discounting the loan. The practical reason in most instances is that the prospective purchaser wants an opportunity to profit through the betterment of the corporation's credit, whereby the market price of the bonds may rise nearer or equal to par. Enhanced market price simply means that investors will be found who are willing to buy the bonds on the basis of a net interest yield which will more nearly approximate, equal, or go below (in the case of bonds selling above par) the nominal interest rate expressed in the bond. They consider that the strength of the bonds warrants their investment on that basis.

On the other hand, the corporation may be able to issue its bonds above par. This may result from the fact that the bonds carry a higher rate of interest than that prevailing for investments of that class. Supposing that there were no other considerations operating upon the corporation, it might have lowered the interest rate and sold the bond at exactly face value; if it chose not to do so, the premium realized must be accounted for as advances by the bondholders to offset in part the interest to be paid to them by the corporation. In ultimate effect, the amount of the premium is returned to the bondholders in periodic instalments. From the standpoint of the bondholder, the purchase of the bond may be regarded as representing a dual investment; first, in a bond bearing the normal rate of interest, and second, in an annuity represented by the premium. The difference between the amount which he receives upon the bond at the specified rate of interest and that which he would have received at the theoretical rate which would have sold the bond at par instead of at a premium, will be the periodic payment upon the annuity.

In determining the nominal interest rate to be specified in

a bond, it is therefore necessary to determine first the price at which the bond is to be sold. It is best, of course, to arrange interest provisions so that the bond may sell at par, but this is not usually practicable. In the determination of the price, the psychology of the market is a strong factor of which the most pronounced phase is the liking that a great many investors have for bonds selling at discount, on the supposition that these offer a better chance of appreciation than a bond purchased at par. Among this class of investors bonds to be sold at a premium are taboo.

As a matter of fact where the price has been determined on the basis of net return, there is no appreciation, all other things being equal, in a bond issued at a discount; and there is no depreciation in a bond issued at a premium. The net yield will be the same to the bondholder in the long run; whether he purchases a twenty-year 4 per cent bond at 93.45, or a twenty-year 5 per cent bond at 106.55—his net return is 4.5 per cent in both cases. In the first instance the appreciation arising from the accumulation, as the date of maturity draws near, operates to restore the correspondence between the nominal specified rate and the actual rate to which the investor was entitled. In the second case the depreciation, as the premium expires, accomplishes the same thing from an opposite direction. An investor of the type of mind which prefers a bond selling at discount because of the chance for appreciation will seldom recognize that a 5 per cent bond purchased at 105.97 when it had fifteen years to run has appreciated in value if sold at 103.12 when only five years of its life remained; the net yield when purchased was 4.45 per cent and on the same basis the value at time of sale would have been 102.44.

Making all due allowances for the temperament and psychology of the investor, it is not good policy nor good finance to issue bonds at too great a discount. The price at which any one issue is marketed may operate to the disadvantage of a future issue. Moreover, issuing bonds at a discount always

requires the assumption of a debt greater than necessary. If \$1,000,000 is the sum required, \$1,250,000 in par value of indebtedness must be issued if the bonds are to be sold at 80. Calling the difference "prepaid interest" or anything else does not alter the fact that the borrower has had to pledge its credit for a greater sum than it has received. Of course, if proper accounting is followed and the discount amortized out of income, there is no substantial harm done. But suppose that a company with \$50,000 capital stock is limited to the borrowing of only \$150,000, viz., three times the amount of its capital stock, and that it requires altogether \$200,000 for the completion of its plant. If the stock were issued for par and the bonds at a discount of 20 per cent, the total proceeds will fall short of the amount required by \$30,000, and yet the company will have pledged its entire credit, leaving no basis upon which to borrow the remainder of the necessary amount.

Practically all public utility commissions now exercise the right of specifying the minimum per cent of par or the price at which bonds may be issued; in fact, they are required to do so because, having certified to the necessity of raising a specified sum for certain purposes by the issue of securities, in order to determine the par value of securities to be authorized for those purposes the commission has to place the applicants upon record as to the price to be realized upon sale. Specific statutory regulations operating directly upon the corporations involved are not common. A proposed federal bill in limiting the interest rate to 6 per cent also provided that the discount should not be "such that taking into consideration the rate of interest and the date of maturity thereof, the net return to the investor shall exceed 7 per cent per annum." The statutes of some of the states provide that bonds may not be issued at less than 75 or some other percentage of par, but these statutes usually are silent as to the nominal rate of interest which the bonds may carry.

The determination of any commission as to the price of

issue never operates to hinder the corporation from making a better bargain with purchasers. The expenditure of the excess proceeds realized by reason of the better bargain must, however, be approved by the commission.

§ 110. Bond Values

The value of all securities bought for investment purposes is, in the last analysis, predicated upon the expected income, since they are purchased for the sake of income. "Value is most significantly expressed in terms of income; indeed, we may say yield is the *only* common denominator of security values."² The rate of income of a security is the ratio which a certain amount periodically received upon the security bears to the price paid for the security. Dividends on stock and interest on bonds are paid at specified percentages of par value. If par has been paid for the share of stock or the bond, the rate of dividends or interest will also be the rate of income to the security holder; but if he paid more or less than par for the security, the rate of income will vary from the expressed rate of dividends or interest to a degree corresponding to the discount or premium at which the security was purchased. The rate of income is usually designated as the net investment return or the net yield.

More particularly, the net yield may be either net dividend yield or net interest yield, the terminology reflecting somewhat the nature of the security to which each is applied. The former relates to securities in which the time element is lacking, such as interminable loans, but most generally to stocks, hence the word "dividend"; the latter relates to terminable loans where the time element is certain and of the essence of the investment.

§ 111. Net Dividend Yield

The net dividend yield is simply the ratio between a peri-

² Lawrence Chamberlain: "The Principles of Bond Investments."

odic payment and the amount invested to secure that periodic payment. It is determined by dividing the amount received by the cost of the security. For instance, if a share of stock is purchased at 110 and the amount of the dividends received semiannually is \$5 (5 per cent on par of \$100), the net dividend yield is $5/110$ or .454 or 4.54 per cent. The factors of the computation are (1) the amount invested, (2) the amount received upon the investment. Stock tables are available from which it is very easy to tell at a glance what the net dividend yield is on stocks bought at specified rates.

A third factor may enter into a theoretical study of the net dividend yield, to wit, a dividend interval. The actual yield of a share of stock paying 8 per cent annually (distributed in a single dividend payment) is less than that of a stock paying 4 per cent semiannually, and still less than that of a stock paying 2 per cent quarterly, since in the case of semiannual payments the net yield in the second half of the year must be increased by the interest which the amount received as dividends for the first half may earn if reinvested. Similarly, in the case of quarterly dividends, the amount of dividends during the year must be increased by the interest which the 2 per cent received for the first quarter will earn during the remaining nine months, the interest which the second dividend will earn for six remaining months, and that which the third dividend will earn for three remaining months. It should be said, however, that only under exceptional and very close figuring will this computation be necessary.

In the above discussion reference has been made to dividends on capital stock, but this is equally applicable to bonds which run in perpetuity, having no date of maturity, or bonds of such a long period as to be practically interminable so far as their present holders are concerned. The revenue received from perpetual loans is not a dividend, since it represents an obligatory payment on the part of the debtor and not a distribution of profits. Interest is an accruing claim, and bonds sold

between interest dates will be sold at an agreed price plus accrued interest; shares of stock, however, are not sold plus accrued dividends ("dividends-on") unless a dividend has been actually declared and payment is pending. Interest which is contingent upon the sufficiency of earnings more nearly resembles dividends and on the New York Stock Exchange income bonds are required to be quoted flat, i.e., without accrued interest.

In the case of redeemable or callable preferred stocks, a fourth element of time sometimes enters into the computation of net dividend return. Where the stock is affected by present conditions indicating the probable redemption thereof, the computation will have to consider the stock as a redeemable security. Its value and interest yield can be ascertained in accordance with the method described below.

§ 112. Net Interest Yield

In the case of securities having a definite and fixed date of maturity, if purchased below or above par, the period to elapse before redemption is a necessary factor in the determination of the value of the bond and of the interest yield, since it is the period during which the discount or premium is to be extinguished and the value of the bond restored to par, at which amount it is payable. The net interest yield will remain constant throughout the period, but the money value of the bond, that is, the amount necessary to be invested to secure the net interest yield desired, will vary, increasing or decreasing as the date of maturity approaches, depending upon whether the bond sells at a premium or at a discount. In the computation of the present value or of the net yield of a bond with a definite and fixed date of repayment, there are two elements which were lacking in the computation of net dividend yield, to wit, the par value at which the bond is payable and the term in years. In this computation the interest interval also becomes a determining factor in connection with the term in

years and the compounding of interest. Hence the factors here are the following:

1. Price
 2. Par value
 3. Nominal interest rate
 4. Term in years
 5. Interest interval
- } = Number of interest periods

Net interest yield and bond values are worked out in great detail in books of bond values. The computation is not an altogether simple one and in view of the fact that tables of bond values are so complete and so much used, it is not necessary to go into the mathematics of bond values. There are satisfactory books on bond values on the market, and the reader is referred to these for a detailed study of methods and bond tables.

§ 113. Accounting for Premium and Discount on Bonds

Referring to bond tables, the value of a $3\frac{1}{2}$ per cent twenty-year bond to yield 5 per cent net interest yield is found to be \$811.73, its value increasing each interest period as follows:

	Value at Close of Period	Accumulation During Period
Purchased	811.73	
First period.....	814.52	2.79
Second period.....	817.39	2.87
Third period.....	820.32	2.93
Fourth period.....	823.33	3.01
Fifth period.....	826.41	3.08
Sixth period.....	829.57	3.16

The purchaser of the bond would set it up in his investment account at cost, \$811.73. At the close of the first interest period he will credit to his income account "Interest Revenues," \$17.50, the amount of the coupon. He will also credit to his income account "Appreciation of Bond Value," \$2.79.

The total amount of the income for the period from his investment will thus be \$17.50 plus \$2.79, or \$20.29. At the close of the second interest period he will credit to "Appreciation of Bond Value," \$2.87; for the third period \$2.93, etc.

On the other hand, the corporation which issues the bond must recognize the full liability of \$1,000. It used to be the practice to carry the amount of discount, \$188.27 in the above illustration, into the "Cost of Road" or "Plant" account, appearing upon the assets side of the balance sheet. The correct practice and that which is now required is for the corporation to set up the amount of the discount in a suspense account, "Unamortized Debt Discount and Expense." At the close of the first interest period it will charge to its income account "Interest Accrued on Funded Debt," \$17.50. It will also carry to an income account, "Amortization of Debt Discount and Expense," \$2.79. In making the latter entry the account "Unamortized Debt Discount and Expense" is credited, decreasing the balance to \$185.48. The account titles used here for the accounting by the corporation are those in the Uniform System of Accounts prescribed by the New York Public Service Commissions. The full text of the instructions for these accounts is as follows:

"Unamortized Debt Discount and Expense. When funded debt securities and other evidences of indebtedness are disposed of for a consideration whose cash value is less than the sum of the par value of the securities or other evidences of indebtedness and the interest thereon accrued at the time the transfer takes place, the excess of such sum of the par value and accrued interest over the cash value of the consideration received shall be charged to this account. To this account shall also be charged all expense connected with the issue and sale of evidences of debt, such as fees for drafting mortgages and trust deeds, fees and taxes for recording mortgages and trust deeds, cost of engraving and printing bonds, certificates of indebtedness, and other commercial paper having a life of

more than one year, fees paid trustees provided for in mortgages and trust deeds, fees and commissions paid underwriters and brokers for marketing such evidences of debt, and other like expenses. At or before the close of each fiscal period thereafter, a proportion of such discount and expense based upon the life of the security to maturity shall be credited to this account and charged to the account 'Amortization of Debt Discount and Expense.' Such discount and expense may, if desired, be amortized more rapidly through charges of all or any part of it, either at the time of issue or later, to the account 'Other Deductions from Surplus.' "

"Amortization of Debt Discount and Expense. Charge to this account at or before the close of any fiscal period that proportion of the unamortized discount and debt expense on outstanding debt which is applicable to the period. This proportion shall be determined according to a rule, the uniform application of which during the interval between the issue and the maturity of any debt will completely amortize or wipe out the discount at which such debt was issued and the debt expense connected therewith. Such amortization may at the option of the corporation be earlier effected by crediting all or any portion of such discount and debt expense to the account 'Other Deductions from Surplus,' immediately upon issue of the debt or thereafter."

Considering now the situation of a bond sold at a premium, upon again referring to bond tables the values of a 6 per cent twenty-year bond yielding 5 per cent are noted as follows:

	Value at Close of Period	Depreciation During Period
Purchased	\$1,125.51	
First period.....	1,123.65	1.86
Second period.....	1,121.74	1.91
Third period.....	1,119.79	1.95
Fourth period.....	1,117.78	2.01
Fifth period.....	1,115.73	2.05
Sixth period.....	1,113.62	2.11

The purchaser of the bond in this case will set up the bond in his investment account at the value of \$1,125.51. At the close of the first period he will credit to his income account "Interest Revenue," \$30, and will charge to an income account "Decrease in Bond Value," \$1.86, leaving a net credit to income of \$28.14. At the close of the second period he will charge to income \$1.91; for the third period \$1.95, etc.

The corporation, on the other hand, must again recognize the par value of the bond among its liabilities. The amount of the premium realized will then be set up among other deferred credit items by a credit to account "Unextinguished Premiums on Outstanding Funded Debt." At the close of the first interest period, in addition to charging to income account "Interest Deductions for Funded Debt," it will also credit to income account "Release of Premiums on Funded Debt" the amortization of \$1.86, leaving the net charge for interest \$28.14. In crediting the account "Release of Premiums on Funded Debt" the account "Unextinguished Premiums on Outstanding Funded Debt" is debited, reducing its balance to \$123.65. The account titles used are those in the Uniform System of Accounts prescribed by the Interstate Commerce Commission and the full text of the instructions for these accounts is here given:

"Unextinguished Premiums on Outstanding Funded Debt. When any issue of funded debt is sold at a premium or issued for a consideration the actual money value of which, at the time of the sale of the funded debt, is greater than the par value of the securities sold and accrued interest thereon, if any, the premium so realized should be credited to a ledger account provided for discounts and premiums on the class of funded debt sold. If the net of the balances in the Discounts and Premiums accounts for all classes of funded debt sold is a credit balance, the amount should be included in this account. At or before the close of any fiscal period there should be credited to the Income of that period (and debited to the Discounts

and Premiums accounts in which the premium is carried) such proportions of the premiums on outstanding debt obligations as may be applicable to that period. This proportion may be determined according to a rule, the uniform application of which throughout the interval between the date of sale and the date of maturity of the debt will extinguish the premium at which such debt was sold."

"Interest Deductions for Funded Debt. This account should include interest on funded debt issued or assumed by the accounting company which has accrued during the period for which the Income Account is stated."

In the above illustrations the assumption has been that the seller at discount will use the same method of writing off the discount suffered as the purchaser will use for the discount earned. The seller, however, is under no obligation to recognize upon its books the sale of the bonds on a "basis"; its only obligation is that of properly recording the fact that a discount has been suffered which must be made good out of accumulated or current income. If it has a surplus account which will stand it, the corporation may charge against it the entire amount. This practice, although allowed by the accounting orders quoted, is not a theoretically correct one, but has much to commend it by reason of its simplicity. The next simpler method is that of writing off the total amount in equal annual instalments. The method of equal annual instalments may likewise be applied to the accounting for premiums earned, but the accounting instructions quoted apparently do not permit these premiums to be credited direct to the surplus account.

If some bonds of one issue have been sold at a discount and others at a premium, it is generally proper for the corporation to offset one against the other, for it is dealing with the debt in total. If bonds of one issue are sold at a discount and those of another issue at a premium, the discount and premium should be separately recorded and the one should not be applied to offset the other; especially would such a practice

be bad accounting if the two issues were at different interest rates.

§ 114. Interest Payable in Gold Coin or Legal Tender

By the terms of many issues, interest is payable in gold coin, in other cases in legal tender. The actual sacrifice made by the payer and the real benefit obtained by the payee may at any certain time be quite far from that contemplated when the bond was first issued or purchased, since the purchasing power of money may have increased or decreased since then. If some method could be devised by which the interest payment could be regulated according to the prevailing value of money in terms of purchasing power, a more stable basis of financing and investing might be possible, but it is very doubtful if any such reform can be expected at an early date.

CHAPTER XI

MATURITY, REFUNDING, AND REDEMPTION OF BONDS

§ 115. Permanency of Funded Debt

The bulk of corporate funded debt now outstanding represents loan capital intended to be fully as permanent as the share capital itself. It is intended to continue throughout the entire period of operations; and the operations of public service corporations, in spite of limitations upon corporate existence in many charters, are presumed to be in perpetuity. On the basis of this theory and presumption it would seem that perpetual funded debt (maturing only upon dissolution of the corporation or the abandonment of operations) would be the rule and not the exception among public service corporations. Although none of the present outstanding issues in this country are so in form and name, they are such in fact, irrespective of indicated dates of maturity more or less distant. The proposed maturity and payment are mere incidents of general financing operations. When the bonds fall due they are refunded by exchange or out of the proceeds of a new issue, so that the debt itself will continue in perpetuity although its form may, many times, be modified.

In addition to the theory underlying the utilization of loan capital, there is also a principle of investment which would logically lead to the issue of interminable bonds. Bonds are not, as a rule, bought with the expectation of realizing profit upon resale or redemption; they are bought for investment purposes, that is, they are held for the income which they produce. Hence, the owner of a bond fully satisfactory as to security and income does not want to part with it; it will be

more agreeable and economical for him to hold it rather than to take the trouble and chance of finding some other investment fully as satisfactory, and possibly suffering loss of income between the date when he had to relinquish his holdings and the reinvestment of the proceeds. Especially in trust funds and estates, the maintenance of a fixed status is very much desired, and reinvestment is a contingency to be avoided. Bonds comprise the bulk of the investments so held.

§ 116. Interminable and Extra-Long-Term Bonds

Governmental securities, supported by the credit of the government, and therefore supposed to possess a sufficient degree of stability and assurance, respond to the principle of investment above expressed. In England interminable securities issued by private corporations are not uncommon. In this country such issues are very rare; indeed, the perpetual, deferred, interest-bearing stock certificates of the Public Service Corporation of New Jersey probably constitute an isolated instance of the kind.

Closely allied to interminable bonds are those with a date of maturity so far removed as to make nil the effect of maturity upon any considerations of rate of income, market conditions, etc. Bonds maturing, say, 500 years from date of issue fall within this class. In the public service corporations field these are almost as rare as interminable bonds; the 500-year first mortgage gold bonds of the Commercial Cable Company, maturing in the year 2397, probably represent almost the sole instance.

In the case of both interminable and extra-long-term bonds the holder is aware that sale of the bond is his only means of liquidating the investment, hence the value of the bond will depend upon the relation of its interest rate to the rates prevailing at the time of offer for sale; the possibility of the bond being redeemed at its par will have practically no effect on the market price. Of course, the question of security will have its

due weight as in any class of bonds. As a rule, the shorter the life of a bond, the more effectively will the face value at which it is redeemable control the present value.

§ 117. Long-Term Bonds

While fundamental theories and principles warrant the use of extra-long-term bonds, many important considerations render expedient a limitation of the life of the debt to a reasonable term of years. The funded debts of many corporations constitute a substantial part of their total capitalization, and the interest charges thereupon are of such large amounts that even slight changes in the rates of interest will materially affect the net corporate income and profits accruing to the stockholders. Accordingly, the fundamental principles of the theory of trading on the equity require the most cautious bargaining in this very respect in order that the stockholders may receive the full benefit of the transaction. Questions of public policy are also involved, for it is easier to regulate the rate and disposition of profits than it is to regulate or modify fixed charges. For these reasons the debtor corporation ought to be placed in a position to take advantage of the shifting interest rates to replace its present obligations with those carrying a lower rate of interest, reducing the annual fixed charges, or making possible the extension of the enterprise from the proceeds of additional bonds without material increase in the burden of interest charges. To all of these considerations must be added the decided preference of investors for bonds of a reasonably limited life, so that the price of issue, market price, rate of income, etc., may reflect the par value of the bond by anticipating payment upon maturity.

The period of years to which the life of bonds is usually limited is thirty, forty, or fifty years, with the five-yearly periods in between. These bonds fall under the general designation of long-term bonds. Bonds covering a period of less than ten years are classified as short-term bonds.

The limitation of the period is controlled by a number of considerations. The use of the proceeds, for instance, may be a very important consideration, as in the case of equipment bonds, or where the proceeds are to be applied to the construction of a building, or where the operations are to be conducted under a franchise for a limited number of years. In all these instances the nature of the assets to be acquired and the term of probable service will govern the duration of the life of the bonds. Undoubtedly the most potent considerations will be those of prevailing interest rates and the conditions under which the issue is introduced. A new corporation, for instance, lacking strong financial connections, or perhaps representing a reorganization, or resting under some other disadvantage which will require the issue of bonds to be at a rate of interest (also considering the price of issue) higher than that warranted under good market conditions or with recognized credit, should limit the term of the bonds to a period no longer than that absolutely necessary to carry the corporation safely into a stage when a more advantageous bargain will be possible. Conversely, an issue made at a time of low interest rates and under very favorable conditions should be for as long a term as possible, with due consideration for the existing financial practice, and the temperament of prospective investors, to save the necessity of refunding at a time when an equally advantageous bargain may not be possible.

§ 118. Short-Term Bonds and Notes

Under this general designation are included all evidences of indebtedness running for a period ordinarily placed at ten years or less. Their place in finance is to supply capital for purely temporary purposes, or to serve as measures of financial "first-aid" so that they may carry the corporation over to a time when it will be able to place an issue of long-term bonds to advantage. Over \$200,000,000 in securities of this nature

were placed upon the market in 1907 and 1908. Those were years of panic and depression when it was well nigh impossible to market any bonds, even at a high rate of interest, so that short-term notes were freely resorted to, running for periods from one to three and in some instances five years. It was then expected that before maturity the market would improve and interest rates return to normal. The expectation was not realized. The notes matured and had to be extended or re-funded out of the proceeds of another issue of notes, while additional new issues of short-term notes were being constantly placed upon the market. Early in 1914, long before the beginning of the Great War which caused another financial relapse, it was estimated that the total outstanding short-term note issues had passed the \$500,000,000 mark in par value. It must be remembered not only that these were issued at comparatively high rates of interest originally, but also that every maturing issue was renewed at equally high if not higher rates and with considerable additional expense in commissions, etc. The device thus proved very costly, because it was resorted to early in the development of a rising market and maturities were not placed safely within the return swing of the cycle; in a falling market the device would have been very economical.

A material incentive to short-term financing began to be apparent at about that same time (1907). The provisions of public utility laws permitting the issue of notes for one year or less without the authorization of regulating commissions, and with the possibility of unlimited renewal (only two states requiring authorization for renewal of funded debt), temporarily placed a premium on short-term financing. Regulation was new; corporations did not know what to expect, and preferred to wait and see what others got; the commissions themselves were new to their tasks and worked slowly at a time when quick action was most necessary.

Another very important consideration influencing the issue

of short-term securities since then has been the discovery of a lively demand for investments of just such a nature. Corporations which at certain seasons had great amounts of cash on hand found it profitable to invest these sums in short-term securities which a few months later could readily be converted without loss into cash to meet the demands of their own business. So much has this method of investment come into favor that there are now investment brokers who will so anticipate the needs of their various clients as to be able quickly to transfer the investment of the one wishing to reconvert into cash to another who is ready to invest a seasonal cash surplusage.

§ 119. Redeemable, Callable, and Optional Bonds

The maturity of a bond may or may not fall into a period when the corporation can refund the obligation advantageously. In the meantime many contingencies may arise because of which the corporation will want to retire a certain issue of bonds before their maturity. That may be done as an incident of reducing the funded debt, or for the consolidation of a number of issues under one general mortgage, or the better securing of another bond issue, or it may form a part of the reorganization of the company's finances in order to refund at a lower interest rate, or to reacquire for the purposes of sinking funds. The bondholder would not, of course, be under any obligation to relinquish the claim before its maturity, and were the corporation forced to resort to individual bargaining every time it wanted to retire or refund certain of its bonds, it would be very badly, if not hopelessly, handicapped. As a measure of protection, therefore, the corporation often reserves to itself the right to redeem the bond before maturity. Bonds issued pursuant to such reservation are usually termed redeemable, callable, or optional. The option may be reserved in provisions whereby the corporation may "redeem" the bonds at any time, after some particular date, or within a fixed

period. The term "optional" is applied especially when the option may be exercised within a period nearer to the time of maturity than to that of issue.

It may also be provided that the bonds to be "called" shall be drawn by lot at stated intervals, the result advertised in the papers, and the bonds immediately retired. Bond issues of this kind hold forth certain disadvantages to the investor. He will be required to be on the lookout for advertisements as to lot drawings; these he may or may not see, but the mere publication of the notice will stop interest accruals. Then, again, out of a number of bonds of the same issue held by one person, only one or two may happen to be drawn, putting him to the trouble of reinvesting the comparatively small sum realized upon the redeemed bonds. No matter what the form in which the corporation is privileged to exercise the option, where the bonds are callable, redeemable, or optional, the bondholder is subject to the contingency of being called upon to reassume sooner than anticipated the care and labor of making a new commitment of capital. He may often be required to relinquish an especially desirable investment for a less satisfactory one, since naturally a corporation would seldom exercise its option unless it were occupying a strong financial position; if its situation were otherwise it would probably be able to reacquire its bonds upon a more advantageous basis by purchasing in the open market.

In the attempt to compensate the bondholder, at least in part, for the disadvantage of being forced to relinquish a claim before maturity, the provisions reserving to the corporation the right to redeem or call its bonds usually require the payment of a premium, or else fix a certain amount above par at which the bonds shall be redeemed, e.g., 102, 103, or 110. Even such a provision may sometimes operate to the disadvantage of the bondholders, for it will set a limitation upon the market value of the bonds. Were it not for the limitation, the bonds might sell at a much higher figure, but, obviously,

few would care to purchase a bond at a higher price than that fixed for redemption, in the face of even slight probability that the option would be exercised.

§ 120. Convertible Bonds

Convertible bonds are those carrying with them an option, vested in the bondholder, to exchange the bond for some other security, usually shares of stock, in certain proportions and upon the dates or within the periods fixed for conversion. There are instances where bonds have been convertible for the bonds of another issue instead of for a share of stock, as for example, an unsecured bond convertible into a secured bond.

The convertible feature generally renders the bond more attractive. If convertible into stock, it superimposes upon the security of the investment the speculative possibility of realizing profits through the increased market value of the stock into which it is convertible. If convertible into other bonds, it may hold forth the possibility of further safeguarding the investment by substituting a better secured bond.

§ 121. Redemption of Debt Upon Maturity

Most of the foregoing has related to indebtedness intended to run in perpetuity. Nevertheless, although the debt itself may be intended to be continuing so far as the corporation is concerned, the bond which for the time being constitutes the evidence of the debt must be paid at maturity. The bond expresses a money indebtedness and when it matures the bondholder is entitled to demand payment in cash according to the terms of the bond; if he accepts anything else, say, a bond of a refunding issue, his acceptance is a matter of bargaining and of choice. The provisions of the bond which relate to payment are therefore of importance.

The bond usually describes specifically the medium of payment, and in this respect bonds are classifiable into *gold bonds*, calling for payment in "gold of the present standard of weight

and fineness," and *legal tender bonds*, payable in whatever may constitute legal tender at the time of payment—sometimes called *currency bonds*. *Silver bonds* are not general now, but they have been common in countries where silver standards prevailed.

This whole subject of the medium of payment is of much more importance than is generally supposed. So far it has received little beyond mere academic attention. For a number of years the purchasing power of gold has been steadily decreasing; a bond purchased fifty years ago and now paid in gold according to its terms will not return to the erstwhile holder a sum of money equal in purchasing power to the sum which was originally given for the bond, although the amounts are expressed in an equal number of dollars and cents. At this particular moment (April, 1918) the depreciation in the value of gold has become serious; the holder of bonds maturing today will probably do better to accept a refunding bond than to accept payment in cash. It is probable that a few years hence the purchasing power of gold will again tend upwards, so that bonds maturing then may bring to the holders a sum of money of greater purchasing power than that which was made available to the corporation at the time of issue. To equalize these fluctuations, both in legal tender and gold, some have proposed that bonds should be made payable upon maturity in such a way that the amount then received might approximate, in terms of purchasing power of commodities, the value of the sum originally accepted. If this were done to any large extent, however, the use of index figures in monetary transactions would have to be standardized and generally adopted.

§ 122. Amortization of Debt

Where the funded debt represents loan capital and is intended to be a continuous one, even though specific issues may mature and be succeeded by other issues, there is no sugges-

tion or necessity of wiping out the debt either gradually or upon any specified date. The immediate burden of loan capital upon the corporate income is for interest alone; the net earnings beyond the interest payments accrue to the benefit of the stockholders—those who are trading on the equity. To provide for the extinguishing of the debt would be to burden the income with periodic appropriations toward the principal of the debt. A long time has elapsed since public service corporations have been allowed to earn anything more than a reasonable return upon the investment, and the opportunity of amortizing their funded debt out of earnings is no longer open to them. None of the railroads, for instance, can attempt amortization, except in the case of equipment obligations. There are but few corporations of other classes which are placed fortunately enough to attempt amortization.

Retiring an issue of bonds in its entirety from the proceeds of another bond issue merely converts the debt into another class; it does not amortize the debt. Similarly, to retire a bond issue from the proceeds of additional stock changes only the form of capital; the debt is discharged, but not as the result of anticipatory provisions which have been currently appropriating earnings or other funds for that purpose. In neither of the above cases is the total capital liability, so to speak, (i.e., the total of capital stock and funded debt outstanding) decreased, and the transactions represent refunding or refinancing, rather than amortization.

To amortize a debt is to reduce the outstanding balance periodically by redemption, or else to provide for future redemption by specific appropriation of earnings and other funds. The two principal methods are therefore those of serial redemption and of sinking fund provisions, discussed in the following sections. Serial redemption may be provided for by having the bonds mature in series, but it may also be effected without introducing differences in date of maturity, by having the corporation reserve options of redemption and

call, and then carry out a fixed program of annual redemption.

The provisions for amortization may have been made by the stockholders as a matter of choice, or they may have been imposed as a condition by the prospective investors in the bonds. If amortization has been required by the creditors, their evident purpose was that of gradually reducing the debt so as to maintain or enhance the security for the payment of the debt as a whole. Usually there is no requirement that amortization be made out of earnings, and the demands of these creditors will be fully satisfied whether amortization is effected through the appropriation of earnings, or the proceeds of capital stock issues or of a junior issue of bonds.

Where amortization of funded debt is provided for at the instance of stockholders, the debt cannot be thought of as constituting loan capital; it is rather a kind of temporary financial assistance extended to the stockholders who intend to wipe out the debt through the income produced by the enterprise. They intend to defer the taking of a part of the profits in order that the debt may be lifted. Where the bonds are redeemed out of the proceeds of moneys borrowed temporarily, the situation is much the same as if they had been redeemed forthwith out of the revenues, since the temporary indebtedness must eventually be wiped out through that channel.

Given an enterprise so situated as to produce earnings sufficient to allow for amortizing the debt, a great many considerations may prompt the stockholders to provide for voluntary amortization. Earnings applied to the discharge of funded debt, in decreasing the debt, increase the free assets and correspondingly the value of the shares; hence, the profit of the stockholder is the same as if an equal amount instead of being applied to the amortization of the debt had been distributed as dividends; in fact, it is more to the stockholders' advantage since with the extinguishing of the debt the amounts theretofore applied to interest charges will go to swell the dividends fund. There is this temporary disadvan-

tage, of course, that the increased share value is not as readily available as dividends would be. Then, again, the destruction of the lien of the debt upon the property increases the security of the stockholders' investment by eliminating the contingency of control passing out of their hands through foreclosure at a time when for one reason or another the interest could not be paid.

§ 123. (1) Serial Bonds

Serial bonds are those of an issue so arranged as to mature a certain number of them at stated intervals, i.e., serially. In contradistinction, bonds maturing all at one time are sometimes called "straight" bonds. Serial bonds are most often used in equipment obligations as before described. Outside of the realm of private corporations, the funded debt of municipalities issued for water-works, gas and electric plants, etc., is very often arranged in serial maturities. The bonds maturing annually or semiannually are retired and the total debt is thereby reduced, the whole indebtedness being wiped out when the last bond in the series matures and is retired. In serial issues no premium accompanies the retirement of the matured bonds, as in the case of redeemable bonds retired before maturity.

In a serial issue the bonds themselves show the date of their respective maturities, hence the purchaser knows exactly the term of the bonds and is subject to no such uncertainty as accompanies redeemable bonds. An investor may therefore choose those having a long or short life according to his own needs. Serial retirement, however, may have the effect of bringing about unequal market values of bonds of the same issue, due to the varying term in years.

§ 124. (2) Sinking Funds

A sinking fund is the accumulation of periodic appropriations so arranged in amount and investment as to have them,

together with their interest accruals, equal a given sum at a future date when the entire accumulation is to be applied to a predetermined purpose.

An approved method for the operation of a sinking fund built up out of revenue is as follows: The annual or semi-annual instalment is charged against the gross income for the period, or against the corporate surplus, as the case may be, through an account entitled, say, "Sinking Fund Accruals"; the corresponding credit is to a balance sheet account appearing on the liabilities side as "Sinking Fund Reserve." This accounts for the appropriation of income or surplus but leaves the appropriated amount among the general assets. If it is desired to segregate the cash or other property into a specific fund, further entries are necessary. The asset set aside in the first instance is usually a sum of money which will be invested later in other property. To carry the transaction through the accounts, therefore, as each appropriation is debited against income or surplus and credited to "Sinking Fund Reserves," the same amount will be credited to account "Cash" and debited to account "Sinking Funds Uninvested." In this last-named account the fund is accumulated pending investment, and when any part of the moneys held therein is invested in other properties, the amount of the investment will be transferred to the debit of an account "Sinking Fund Investments," having been concurrently credited against the account "Sinking Funds Uninvested." The income accruing from the investments in the sinking fund will go to increase the fund awaiting investment, unless there is an understanding to the effect that the income shall go to the corporation and that only the fixed appropriations to be made by the company will be looked to for the accumulation of the sinking fund. The most usual situation is that the increment of the fund constitutes accretions to it. The corporation will take the income from the investments into its own general income account as interest or dividends received, and then transfer the

amount thereof to the debit of "Sinking Funds Uninvested," having charged the amount out of income or surplus through the same accounts as were used in accounting for the regular appropriations. When the bonds in respect of which the sinking fund was created fall due, the investments are sold and the proceeds applied to the extinction of the debt; the investment account is credited and cash account debited for the liquidation of investments, while for the payment of the debt "Cash" is credited and "Funded Debt" debited. The sinking fund reserve remains undisturbed until its balance is transferred to surplus account or appropriated to some other purpose.

Whether the sinking fund appropriations shall be charged against gross income and before arriving at the net income to be transferred to Profit and Loss account, or whether they shall be charged directly against Profit and Loss account, is a debated question. Some accountants distinguish between sinking fund appropriations made pursuant to mortgage provisions and those made from the choice of the corporation. They would charge the former against gross income in much the same manner as interest, but would charge the latter against the Profit and Loss account. The theory is that in the former case the appropriations represent contractual charges presumably relating to the cost of acquiring the use of money, while in the second case they merely earmark certain portions of surplus set aside by the stockholders, and designated for a particular purpose the accomplishment of which will release the accumulated appropriations to the benefit of the stockholders. This method is the one prescribed by most of the state commissions and the Interstate Commerce Commission. On the other hand, there are accountants who contend that since the operation of a sinking fund accumulated out of income is ultimately to increase the stockholders' equity by the amount of the debt discharged, the several appropriations thereto, whether made pursuant to contractual requirements or

voluntarily, should be recorded as profits accruing to the stockholders even though their immediate disposition is subject to limitations. They hold that to charge these appropriations against gross income before arriving at the net income is to understate the actual profit for the period. The contention is not without merit. Under its application the appropriations would be charged against the Profit and Loss account to represent what they in fact are—profits of the corporation withheld from dividend distribution either voluntarily by the corporation or because of contract requirements, pending the accomplishment of a certain purpose, to wit, the reduction of the debt. As against its logic, however, there must be weighed the desirability of having all the fixed financial responsibilities of the corporation taken care of before the income for the period is recorded; this makes it eminently proper to give due consideration to the purpose of the sinking fund in adopting an accounting rule and practice.

The foregoing paragraph has dealt solely with sinking funds accumulated out of income. The effect of the methods described is that of setting aside in the first instance a part of the earnings. There are some accountants who claim that in the absence of specific provisions of the mortgage requiring accruals to be charged against income, the corporation is at liberty to make the accumulation from any source whatever, even from borrowed moneys or the proceeds of stock issues. Those who make this claim will not record any setting aside of earnings or surplus but will simply set aside certain of the assets to constitute a separate fund. The entries affect only balance sheet accounts, shifting assets; there will be no "Sinking Fund Accruals" account in the income statement and no "Sinking Fund Reserve" on the balance sheet. It is difficult to justify the propriety of such a method; if the correct theory and legitimate purposes of a bona-fide sinking fund are to be carried out, the transaction should be handled through the general income account of the corporation.

§ 125. (3) Effect of Serial Maturities or Sinking Fund Accruals

The effect upon the debt of serial maturities or sinking fund provisions is substantially the same. It is very much as if a man owing a mortgage debt agrees with the mortgagee to pay him \$100 on the principal on each interest date, or, failing to make the agreement, puts away in a savings fund \$100 upon each interest date, figuring that he will thus have saved enough by the date of maturity of the mortgage to pay it up. In other words, he is amortizing the debt.

In the case of equipment obligations we have already noted how serial redemption increases the equity of the bondholder. In precisely the same manner sinking fund accruals enhance the equity of the bondholder and for that reason prospective bond purchasers have often bargained that a sinking fund be provided to supplement the security. For instance, in the early years of electric railway operations, with the history of the change from animal traction to cable still fresh in the minds of the investors, the future of companies engaged in these operations seemed more or less speculative, so much so that provisions for the accumulation of funds to pay off the mortgage upon maturity were often deemed prudent and desirable.

In further reference to equipment obligations, the relation between serial redemption and accruing depreciation was also pointed out, the underlying theory being stated as that of amortizing the debt along with the decrease in the value of the asset standing back of the debt; in other words, of making the property pay for itself. The same theory is applicable to the amortization of debt by the sinking fund method, hence it has sometimes been thought to constitute only another form of providing against depreciation. Under correct depreciation accounting, one aim is to maintain the integrity of the bondholders' security by having on hand an amount sufficient to make good the reduction in capital account so as to maintain

the same proportionate relationship between the value of the property and the outstanding debt as existed when the bonds were first issued. So far as protection of the bondholder is concerned, therefore, the aims of the two methods are very much the same; in fact, they may be said to be identical to the extent that the one would make the other dispensable. A differentiation, if one must be found, may lie in this, that while depreciation reserve provisions assure against loss in the value of the property itself through depreciation alone, sinking fund provisions assure against loss in the undertaking as a whole. In the instance of a natural gas corporation, for instance, a depreciation reserve based upon the physical property in use would be a very inadequate measure of protection, while depreciation to provide for the exhaustion of the wells could be little more than pure estimate; an adequate measure of security could be afforded, however, by provisions looking to the amortization of the debt.

It should also be noted that depreciation is accounted for in operating expenses, while sinking fund appropriations are deductions from the gross income or surplus. In relation to the comparison of results produced by depreciation accounting and sinking fund provisions, it needs to be further noted that in the latter case there is always deliberate purpose to have the accumulation progress at a more rapid rate than the loss in value, hence the equity is constantly increasing. In depreciation accounting, however, the current charges are intended to equal, neither exceeding nor falling under, the current loss in value, so that the equity remains constant. Very often, of course, no relation whatever will be found between a bond issue and specific assets, so that the sinking fund provisions cannot even be assumed to have been based in any way upon the measure of the current depreciation of the assets; in fact, the assets securing the issue, as a whole, may actually appreciate in value.

The fundamental distinction, of course, is that sinking

funds are required for the benefit of the creditor, while depreciation accounts are for the benefit of the business itself.

In a serial issue, certain of the bonds mature periodically, and as they mature they must be retired. When the term is absolute, failure to meet payment of a matured bond constitutes default of the entire outstanding issue and subjects the property to foreclosure, hence great efforts will be made by the debtor corporation to meet each maturity. Serial redemption is therefore the most certain method where the debt must be amortized, as in the case of equipment obligations or bonds issued against natural resources, e.g., those of a natural gas corporation. It is true of serial bonds, however, that more often than in the case of sinking fund appropriations the retirements will be effected out of the proceeds of moneys borrowed or acquired from sources other than the current income.

§ 126. (4) Equalizing Annual Burden of Amortization

In every problem of amortization the most important factor is the equitable distribution of its burden throughout the period of amortization. The burden of a debt which is not intended to run in perpetuity consists of the obligation to pay interest and to meet the maturity of the principal. The purpose of amortizing the debt is to distribute the aggregate burden over the life of each debt. Serial maturities are generally arranged in equal annual or semiannual maturities. This evenly distributes the principal but not the interest of the debt, hence the aggregate burden is heaviest in the earliest years and grows lighter as the period of amortization advances; that is to say, in many cases this places the heaviest burden at the point where the corporation is least able to carry it, to wit, when the enterprise is new and before its full earning capacity has become developed. To remedy this defect the serial maturities may be so arranged that the sum of annual interest charges plus the maturities will be equal in each year; as the interest decreases each year with the dimin-

ishing principal, the amounts maturing will be correspondingly increased. Issues so arranged are spoken of as *equal installment bonds*. Through the sinking fund method the burden may be still more evenly approximated, since calculations may be exactly carried out, and the annual or semiannual appropriations do not need to conform to the par value of maturing bonds.

§ 127. (5) Sinking Fund Investments

The operation of a sinking fund requires the actual setting aside of funds, and the disposition of that fund during the period of accumulation becomes very important. The corporation may do one of four things: it may hold the fund in cash, uninvested; it may invest the fund in purchasing bonds of the issue to which the sinking fund relates or of another of its own issues; it may invest the fund in securities other than its own; or it may invest in its own operations. The provisions of the mortgage itself may be controlling as to the disposition of the fund.

The accumulation of a cash fund is practically out of the question, since it would be the worst policy or practice to allow large cash reserves to accumulate and remain idle, earning at best but a very low rate of interest.

The second option open to the corporation is that of investing in its own securities of the identical issue to which the sinking fund relates or of another issue. In the former instance the corporation is practically retiring the bond issue serially, except that it is not subject to the demand of any bondholder as it would be to the holder of a matured serial bond, and it can seek and await the opportunity of reacquiring its bonds upon the most advantageous terms. Requirements that the fund be invested in purchasing bonds of the issue to which it relates are the most usual. The bonds so reacquired are placed with the trustee under the mortgage and marked "Not Negotiable." This is undoubtedly the most advantage-

ous method, as it accomplishes a number of desirable purposes. It actually retires the debt gradually; it obviates the exercise of judgment in selecting a proper investment; it saves the corporation possible loss in unwise investments; by making the corporation a constant bidder for its own bonds, it helps to maintain the market values of the issue, indirectly promoting the credit of the corporation.¹

It is somewhat of a misnomer to designate as "investments" the bonds so reacquired, since the term carries a collateral implication that there is somewhere an outstanding obligation creating a claim sufficient to constitute an investment; however, many corporations insist upon considering the full amount of the issue as outstanding and include among their assets the value of the reacquired bonds. Manifestly a corporation cannot, any more than an individual, owe to itself; even the law with its many fictions could never recognize a private resolution as creating any right or claim accruing to the benefit of someone else. It would be far better for the corporation to show as its funded indebtedness only the net amount after deducting the par value of the reacquired bonds, making the necessary adjustments between the par and the purchase price through its Profit and Loss or Sinking Fund Accruals account. The accounting requirements of many commissions require such treatment. Where the corporation invests in its own bonds of an issue other than that to which the sinking fund relates and which it may reissue, the securities perhaps cannot be logically considered as finally retired and the corporation may be warranted in including them among the investments, but it should always show separately holdings of its own securities.

The third option enables the corporation to invest the fund in securities other than those issued by itself. Investments

¹ It may be asserted that an artificial demand may be created which will result in inflation of market values. To produce that effect the corporation must be in a position to buy back large numbers of bonds and to pay the higher prices demanded; it will, therefore, be anxious to restrict its purchases if the price is unreasonable, and the situation will usually correct itself.

thus made, as also the cash in the fund awaiting investment, are always subject to the specific lien of the mortgage of which the sinking fund provisions, if the fund is a contractual one, are a part. Substantial objections can be raised against this disposition of sinking fund, both from the standpoint of the bond and stock holders, and from that of general public policy. The safety of the fund is here made dependent upon the prudence and wisdom exercised in the choice of investments; the risk of the investment is added to the risk of the corporation's own enterprise. Then, again, a serious difficulty arises in properly correlating the income derived from the investment to the interest upon the bonds to which the fund relates; if the corporation pays 6 per cent on its own bonds it must get at least as much upon the investments of the sinking fund if it is to avoid actual loss. Moreover, where the fund is to be invested in outside securities, it is not possible to make correct computation in advance, since it is not possible to predict at what price the securities will be purchased, when they may be acquired, and what the net yield will be. Again, when the bonds mature and the sinking fund is about to be applied to the discharge of the debt, it may not be easy to realize advantageously upon the investments of the fund. A situation which would be condemned by general public policy might arise if the sinking fund were of a large amount, causing the investment operations of the company to become relatively of as great importance as its public utility operations.

Upon the assumption that the corporation in its own operations can earn more than the rate of income derivable from investments either in securities of other corporations or in its own bonds, it is to the greatest advantage of all parties concerned to have the company use the fund in extending its own enterprise. The fund will then be distributed among the general assets of the corporation and will not be separately identified, its accumulation being indicated only by the reserve account which will record the current appropriations. If the

provisions for amortization of the debt are voluntary on the part of the corporation, this method is the most satisfactory, but if they are contractual, the setting aside of an actual fund is usually necessary.

Throughout this entire discussion the implication has been that the corporation has complete control over the sinking fund and its investments. Practically in all instances where the fund is a contractual one, the trustee under the mortgage is also the trustee of the fund. Ostensibly it is the trustee who makes the investment; all securities are placed in his care, and all payments on account of the fund are made to him. He may well be considered, however, as the agent of the corporation, since his expenses are the expenses of the corporation and his investments are the investments of the corporation, which remains the beneficial owner. Some people try to draw a very sharp distinction between the trustee and the corporation in this respect; and where the trustee holds bonds of the identical issue to which the fund relates they claim that it is the trustee who has purchased and continues to hold the bonds so that the corporation will be required to recognize them as valid outstanding claims. But since the trustee will hold these bonds until the fund has served its purpose of redeeming the entire issue, and he will have no authority ever again to place them in other hands, the distinction would seem to be drawn too finely and to be unnecessary for any legitimate purpose of corporate finance or accounting.

§ 128. (6) Extent to Which Sinking Funds Are Now Used

Sinking funds are not as common as they used to be; it has become generally recognized that there are better ways of safeguarding the security holder. With the advent of public regulation and the growing size of corporations, it is becoming more and more important that capital, whether loan or share, be treated strictly as capital. Moreover, the rate

of return allowed does not contemplate instalment payments upon the principal of the capital.

"Twenty years ago sinking funds were considered a usual and proper safeguard of railway loans, but the experience of the lean years following the panic of 1893 destroyed faith in their efficacy, for about 25 per cent of all railway obligations so secured, defaulted. It came to be realized that sinking fund accounts could be subject to manipulative tactics which would render them a source of expense and loss of credit rather than of income and confidence. For instance, where earnings did not admit payments to the sinking funds (which in accounting are a charge prior to interest payments), new bonds were issued to raise the money necessary for sinking fund payments, so the total debt was increased rather than decreased, with consequent loss of net earning power and credit. Thus it was realized that the best reinforcement of an obligation was obtained by putting the surplusage back into the property, and by refunding bond issues as they matured, on the strength of an increased credit, and therefore at a lower rate of interest.

"It is evident, however, that this fiscal policy will not always be best for small companies, or for companies owning properties which must be depleted to produce revenue (wasting assets). It is imperative, for instance, that the outstanding obligations of a coal company should lessen, as the supply of its marketable product lessens."²

² Lawrence Chamberlain: "The Principles of Bond Investments."

CHAPTER XII

RELATION OF BONDS TO STOCK

§ 129. Importance of Proper Proportion Between Stocks and Bonds

The proportion of the total capital to be represented by bonds and that to be represented by stock is often one of the most difficult questions in the organization of a corporation, or in subsequent modifications of its financial status. In some few happy instances this proposition offers no problem at all; the incorporators have estimated carefully the sum necessary for the enterprise and are in a position to approximate the return that will be produced upon the total sum to be invested. They have ascertained also the total amount of capital which they are themselves able or willing to commit, so that the difference between that and the sum required for the enterprise is the amount to be procured through the issue of bonds. In by far the greater number of instances, however, the question is a very complicated one and the answer thereto must be evolved out of considerations of market conditions, the current demand for investment in stocks or in bonds, the rate of discount and of interest, the credit of the incorporators and the repute of the enterprise, the prospect for earnings, etc. All of these matters demand serious and careful thought; a proper admeasurement of the relative force and significance of each of them becomes the specialized business of the banker.

§ 130. (1) Earlier Tendency Toward Greater Proportion of Bonds

In the public service corporations the tendency has been to maintain and increase the proportion of bonds to stock. This

has resulted in the now insistent public complaint that railroads have been built out of the proceeds of bond issues; that bonds represent the true capitalization and the stock represents the "water." To bear out this complaint "physical valuation" of railroad properties has been widely demanded and is now under way. The complaint may be well founded in some cases, but it certainly is not true of all railroads and still less true of other public utilities as a whole. The Interstate Commerce Commission has reported the aggregate capitalization of all railroads in the United States as of June 30, 1915, to be approximately \$19,700,000,000, of which about 56 per cent or \$11,100,000,000 was represented by bonds and other certificates of indebtedness, and 44 per cent or \$8,600,000,000 by stocks.

This tendency has been ascribed to a disinclination on the part of stockholders to put their own money into these enterprises, relying instead upon the proceeds of bond issues. The Committee on Capitalization of the National Association of Railway Commissions reported in 1913:¹

"If we should attempt to name the one factor which has been most productive of financial troubles and which has contributed most to the necessity for regulation we would have no hesitancy in saying that it has been the design of the men promoting and controlling utilities to make somebody take the risks and they themselves take the chances of profit, and not even today when utilities are supposed to be very much reformed do we find stockholders adverse to getting their stock for nothing and taking the chance that value may be placed behind it out of the rates which the utility will be permitted to earn. The building of utility enterprises entirely from borrowed money is so illogical that it would seem not worthy of discussion were it not for the fact that it not only has been the practice in the past but it is a practice too prevalent today, and if it is illogical and unsound financing to

¹ Published in proceedings of the Convention, page 189.

borrow all the money which goes into a utility originally, for the same reason it is illogical and unsound financing to borrow more money to make extensions or improvements for the utility that has originally been so constructed."

The Railroad Securities Commission in its report had also referred to the same subject in the following words:

"One of these evils" (resulting from the practice above described) "was that the bondholders were at times deluded into the belief that there was a security behind their bonds which did not exist, and that the railroad company was mortgaging a piece of property when it was only capitalizing an expectation. They thus entrusted the control of their money to men who had comparatively little at stake. If a profit was made, the promoters could appropriate it; if money was lost, the loss fell on the bondholders. Roads built largely with borrowed capital at the beginning have been prevented from subsequently obtaining the credit which they might otherwise command. They have therefore been less able to give to the shippers or to the travelers the facilities which are requisite no less for the convenience and safety of the public, than for the profitable utilization of the railroad itself. To the extent that we lessen debt, we shall increase the powers of the roads to raise money when the public needs added facilities and shall at the same time reduce the chance of default and lessen the severity of commercial crises."³

"The Government cannot protect the investors against the consequences of their unwisdom in buying unprofitable bonds, any more than it can protect the consumers against the consequences of their unwisdom in eating indigestible food. Unless we are prepared to have government guarantees of interest on railroad investments—a most questionable proposal—the only way in which we can standardize railroad mortgages is the one which we use with savings banks mortgages. We can insist upon double security. We can say that at least half the

³ Page 17 of report.

capital of a railroad must be subscribed by stockholders, and that no more than half may be raised by borrowing—a difficult requirement under existing conditions.”³

If error has been made in unduly expanding the proportion of bond to stock issues, it is not just to lay the entire blame on the promoters and managers of corporations whose capitalizations indicate such a disparity; much less is it fair to impute to these men fraudulent and corrupt motives. On the contrary, most of the men who have projected and developed epoch-making ideas and enterprises have been men of sterling character and unquestioned motive; men who have deserved far better treatment at the hands of the communities whom they have served than that which has been accorded them. Not a little responsibility for the disproportion of bond to stock issues, where it exists, should be placed upon the investors, bankers, brokers, and academicians, who seem to have become attached to forms rather than the substance of securities; who have taken and recommended securities for investment because they were called “bonds” and have discredited more promising securities because they were called “stock,” all the time being utterly ignorant as to the true merits of the securities offered. With an unquestioning, unscrutinizing and open bond market, is it any wonder that some promoters in their anxiety for economical and quick financing should have sought to carry out their financing schemes largely through bond issues? Also the great number of existing accredited depositaries of bond investments encourages bond financing.

§ 131. (2) Earlier Tendency Correcting Itself

In recent years the tendency has shifted in the opposite direction, to wit, toward increasing the proportion of stock to bonds. The shift is undoubtedly due in no small measure to the increased protection afforded to stock issues through public regulation which has restored public confidence in the

³ Page 31 of report.

merits of this class of securities. In ultimate theory there is no question that the best method would be to finance these enterprises wholly by capital stock issues; there will be advantages more than offsetting the loss suffered by the stockholders who might want to "trade in the equity." It would mean much toward maintaining corporate organizations and assuring their ultimate success on a moderate capitalization.

The introduction of the rights of mortgage creditors in corporate finance has resulted far too often in needless and premature financial reorganization of enterprises which have not been able to become immediately successful, to the great loss of many investors and of the communities served. The stock and bond capital of corporations which have gone through reorganization has come back to the surface larger than before default, with no increased assets to offset the increase in capitalization; also, there is placed upon the enterprise the task of earning, over and above operating expenses, interest on an excessive loan capital, and, if possible, dividends on the inflated share capital, while the conditions under which that task is to be fulfilled become more unfavorable than before reorganization because of loss of credit, change of management, curtailment of extensions, etc. Nevertheless, the place of bond issues in the capitalization of corporations has become definitely fixed. In addition to the extra profit accruing to stockholders through the excess earnings of loan capital over the amount paid in interest, these issues serve the very valuable purpose of making possible the extension of a corporate enterprise without increasing the number of stockholders; otherwise the door might be opened to admit a change in control and management, to the disadvantage of other stockholders and probably of the public as well.

§ 132. (3) Stockholders' Investment Should Support Loans

Of the relation which ought to exist between the contributions of stockholders themselves and the sums borrowed

from holders of debt certificates, the Public Service Commission of the Second District of New York, said in an early case:

"It would seem to be essential in order to give credit to any bond issue, that there should be an amount of actual money invested by the stockholders in the enterprise sufficient to afford a moral guaranty that in the judgment of competent business men it is likely to prove commercially successful and that men of judgment and experience are willing to invest their capital in it with no assurance of returns upon that capital except those coming from the legitimate profits which may reasonably be anticipated. It would also seem essential in the present state of development of railroad enterprises, that any scheme which would receive the attention of capitalists should present features making it fairly certain that the road will pay its operating expenses, its taxes, and its proper depreciation charges, and leave a surplus above them for the payment of fixed charges."⁴

In a case heard subsequently, where it was proposed to pay for the extension of an electric railroad out of the proceeds of a bond issue alone, the Commission reiterated the principles expressed in the case above cited and added:

"To the opinion thus expressed this Commission still adheres without the slightest abatement in any respect, except that decisions of the courts made since the opinion was written and since the opinion was promulgated have placed in more than doubt the power of the Commission to determine whether capitalization should be by stock or bonds alone or a division of the same between the two, against an expressed determination of the corporation itself. If the Commission clearly and unequivocally possessed the power which it then supposed it had, it would exercise the same in this and every other case in accordance with the principles above enunciated.

⁴ Rochester, Corning and Elmira Traction Co., 1 P. S. C. Rep. (2nd D., N. Y.) 166, 188.

"The applicant insists upon issuing bonds for the entire amount..... If it were clear under the Public Service Commissions Law, as interpreted by the courts, that we had power to require a proper proportion of stock in this case, that power would be unhesitatingly used provided the facts showed that an additional issue of \$806,000 of bonds supported by a stock issue of \$84,000" (then outstanding) "of which in our judgment \$75,000 was bonus stock, was inconsistent with the principles laid down in the Rochester, Corning, Elmira Case."⁵

The applicant's contention was that stock could not be sold, and that if the bond issue were not authorized, the proposed extension could not be constructed. Facing the alternative, the Commission authorized the issue after inquiring as to the applicant's probable ability to pay the resulting fixed charges and reporting that "it cannot prove by affirmative evidence that the returns will not be as great as those claimed by the company. However great the improbability, it must be admitted that it is theoretically possible that the earnings may take care of the interest upon the bonds as well as pay operating expenses and taxes." The authorization was approved by a bare majority, "two commissioners believing that the application should be granted only with a reasonable proportion of stock, leaving the courts to decide whether such course is within the Commission's power." The majority opinion itself pointed out that "when built there will be no equity in the property behind the bonds to support and protect the bondholders' lien except the \$9,000 paid in cash upon the stock." Throughout the entire opinion there is evident an attempt to disclaim responsibility for the authorization, while the status of the bonds is described in language which, to say the least, would not be advertised by brokers attempting to dispose of the bond issue authorized.

⁵ Hudson River and Eastern Traction Company, 3 P. S. C. Rep. (2nd D., N. Y.) 172, 177-182.

"Purchasers of these bonds must understand clearly that in no event can they get more than 5 per cent per annum upon the face of the bonds as the return, while if the earnings are not sufficient to meet the fixed charges there will necessarily be a default, whereas if the same bondholders owned all the stock instead of bonds they would get as returns all that the road earned above operating expenses, taxes, and amortization, and would run no more risk than they do now upon getting their interest returns. Bondholders cannot expect 5 per cent return unless the business of the road assumes the magnitude claimed by the company. Bondholders take the risk of smaller earnings, the risk of the road not being properly kept up out of earnings, and in fact every risk there is in the operation of the road, there being practically no equity behind represented by stock investment. It is possible for every evil which ordinarily follows from a disproportion of bonds and stock, to be found in this case. We are unable to understand why persons with over \$600,000 to invest should be willing to do so for a 5 per cent return plus a 20 per cent discount on long-term bonds, knowing they can get nothing beyond what the road earns, when by taking stock they could get all it earns net. But such seems to be the case.

"The company insists upon building its road on bonds which it says it can sell. It says that it can sell no stock whatever even with the attractive financial conditions above outlined. . . . The responsibility of deciding this question should be placed upon the board of directors, under all of the circumstances of this case, and should not be assumed by the Commission. There is no positive provision of law which requires the Commission to assume this responsibility, and whatever responsibility it has in the matter is not imposed by statute but simply by its desire to see methods of financing new construction adopted which will adequately protect purchasers of securities. It must distinctly disavow in this case any responsibility to the purchasers of the bonds as to the

earning power of this road, or as to the probability or possibility, even, of the road paying its fixed charges. The directors must assume all responsibility of putting out upon the world these securities and of inducing the people who have not studied this subject to invest their money. People who do invest their money in these bonds must make their own conclusions as to their worth and as to the probability of their being worth the sum paid for them. The Commission cannot undertake in this case to act as guardian for them, and from the authorization of these bonds by the Commission it must not be understood by any one that the Commission considers them a safe and prudent investment."

This opinion has been quoted at length not only because it describes dangers resulting from disproportion of bond to stock issues, but also because it affords an excellent illustration of the ambiguities which may result from too narrowly restricting the scope within which commissions may exercise discretionary authority. The applicant had proposed a purpose wholly within the statute and was thereby entitled to authorization to finance it; the Commission was thus called upon to authorize an issue technically within the statute but inherently capable of producing the very results which the Commission had been created to obviate. The Commission's authorization, under the construction of the statute then very recently handed down, would under such circumstances become largely ministerial and not discretionary, while it would be proclaimed far and wide as a practical indorsement. Where it thus lacked the power to deal positively and constructively with the application before it, the Commission had to deal negatively, as it were. Where it could not give practical effect to its convictions, it took advantage of the opportunity to register those convictions so as to obviate any misconstruction of the nature of its authorization. The order in this case specifically provided that each certified copy procured from the Commission should have a copy of the opinion appended.

§ 133. Statutory Provisions Regulating Proportion

The proper relation between stock and bond issues has been considered important enough for statutory provision. The Railroad Commission Act of Massachusetts specifies that a railroad corporation may issue "its bonds, notes or other evidences of indebtedness . . . to an amount which when added to the amount of all its then outstanding bonds, notes or other evidences of indebtedness shall not cause the aggregate amount of its bonds, notes and other evidences of indebtedness to exceed twice the amount of the capital stock of the corporation actually paid in at the time as determined under provision of Chapter 620 of the Acts of the year 1906."

A Model Public Utilities Act drawn up by the National Civic Federation contains a clause which makes the determination of a commission controlling. The clause follows substantially the Wisconsin law on the same subject; it is merely declaratory of a principle.

"8. Relative proportions of stocks and bonds. The amount of bonds, notes and other evidences of indebtedness which any public utility may issue shall bear a reasonable proportion to the amount of stock and certificates of stock issued by such utility, due consideration being given to the nature of the business in which the corporation is engaged, its credit, future prospects and earnings, the effect which such issue will have upon the management and efficient operation of the public utility by reason of the relative amount of financial interest which the stockholders will have in the corporation and the circumstances surrounding the operation and business of the corporation."

The Public Utilities Act of California provides: "The Commission may authorize issues of bonds, notes or other evidences of indebtedness less than, equivalent to, or greater than the authorized or subscribed capital stock of a public utility corporation and the provisions of sections 309 and 456 of the Civil Code of this State in so far as they contain inhi-

bitions against the creation by corporations of indebtedness, evidenced by bonds, notes or otherwise, in excess of their total authorized or subscribed capital stock shall have no application to public utility corporations."

As an example of the legislation of foreign countries may be cited the provisions of the Italian law prohibiting the issue of bonds for an amount exceeding the unimpaired paid-up capital stock of the corporation, unless the excess of bond issue is guaranteed by a deposit of national, provincial, or communal bonds.

§ 134. Considerations Governing Determination of Proper Proportion

The report of the Committee on Capitalization of the National Association of Railway Commissioners, already referred to, states generally that "the ideal relationship between stocks and bonds is that which allows the corporation to apportion its legitimate earnings upon its investment so as to maintain the highest degree of credit and at the same time pay generous dividends to its stockholders and retain a working surplus."⁶ The test here described is without question the measure of the proportion most advantageous to all concerned—stockholders, bondholders, and patrons of the utility. The determination of the proportion which will answer this test, however, cannot always be predicated upon an arithmetical formula which will first determine the earnings, and then, by assigning so much for interest charges, so much for dividends, so much for surplus, etc., arrive at the total required amount of bonds and of stock. There are a great many other considerations any one of which may, under a particular set of circumstances, become controlling. A number of factors to be considered are specifically referred to in the section above quoted from the Model Public Utilities Act.

The considerations which most often determine the pro-

⁶ Page 198 of Proceedings, 1913.

portion of bonds to stock may be grouped and discussed from three viewpoints. The first is that of corporate control; the second, the prospective earnings and the equitable apportionment of those earnings to interest, dividends, etc.; the third, relative facilities and economies in marketing securities of the respective classes. The order in which these items have been enumerated here does not represent an attempt to indicate their relative importance. It is impossible, apart from a statement of facts, to assign relative degrees of importance to these matters.

§ 135. (1) Considerations of Corporate Control

The importance of considerations affecting the status of corporate control to be established or disturbed by a new issue of securities is noticeable in the following cases: (a) where the capitalization is moderate and the stock is to be held by a small group of men who are to undertake the conduct of the enterprise; (b) where the corporation is organized in the interest of a syndicate or a holding company which will take and hold all the stock; and (c) where the corporation is organized as a feeder to a railroad or as an extension of the enterprise of some other public utility corporation which will take and hold all or a majority of the stock. In all of these cases the question of control is a very important consideration; the size of the stock issue is determined by the amount which those who are to control the enterprise can themselves invest, either through committing their own capital or themselves borrowing from others, e.g., by means of collateral issues. The problem here becomes, especially in the last two cases, how to secure the necessary capital with a minimum investment on the part of those who are to acquire and maintain control. Choosing one railroad system almost at random, for the purposes of illustration, it was found that the total capitalization of the principal company was divided in the proportion of 43 per cent stock to 57 per cent bonds, while the com-

bined capitalization of its subsidiary companies (including all controlled corporations, whether originally organized on behalf of the principal company or as independent projects which were later absorbed) was divided in the proportion of 29 per cent stock to 71 per cent bonds.

In many instances where operating companies attempt to finance an extension of their enterprises, the possibility that additional issues of stock may disturb the established control constitutes a most important consideration. Additional issues of stock are first offered to the existing stockholders; if they cannot absorb the issue, and if control of the company is a matter to be eagerly competed for, bonds will be needed to supply the greater proportion of the desired capital.

§ 136. (2) Adequacy and Apportionment of Earnings

A bond issue imposes a burden of interest charges which must be met currently out of earnings. It is, therefore, a fundamental consideration that the total debt shall not be such as to impose a fixed burden of interest charges greater than the annual earnings, conservatively anticipated, will warrant, with due allowance for the necessity of providing out of those earnings for all other classes of fixed charges and for dividends on stock, as well as appropriations to build up necessary reserves and surplus. The limitations of the bond issue resulting from this consideration are inescapable. In the Rochester, Corning, Elmira case already quoted from, the Public Service Commission discusses this consideration very fully:

“Such division” (of total capitalization between stock and bonds) “should be made upon principles easy of comprehension, just in their application and productive of good results in the actual conduct and operations of the corporation. It is apparent that when we have fixed the amount which should be permitted in bonds, we have necessarily fixed the amount which should be allowed for stock, and it is well, therefore,

to inquire whether we may not determine the division between the two by an inquiry into the permissible amount of the bond issue. It is believed that it would be of incalculable value to the successful development of corporate enterprises if there could be reasonable certainty that they would take care of the fixed charges entailed by bond issues. Certainty of the payment of interest with practical certainty of payment of principal cannot be overestimated as to their value in forwarding such enterprises.

"We conceive that we should not permit an issue of bonds beyond an amount upon which, in our judgment, the enterprise will be able to pay interest. While this Commission cannot in any respect be responsible any more morally than it is legally for returns upon bond issues which it authorizes, it would certainly be derelict in its duty to the public if it permitted a bond issue upon which it was not fairly reasonable to expect that the interest would be paid from the legitimate earnings of the enterprise. It must be clearly understood that in arriving at conclusions upon so important and delicate a point the Commission cannot arrive at results satisfactory to itself and to the public except upon a conservative basis, and it would be in the highest degree reprehensible for the Commission to permit any corporation to offer bonds upon the market which the Commission, in the exercise of its best judgment and with full command of all the statistical data regarding the operation of roads within this state, did not feel to have a reasonably satisfactory assurance from all the circumstances of the case that the interest would not be defaulted.

"The amount of the bond issue may fairly be determined in the following manner: An estimate should be made of the probable gross earnings to accrue from the operation of the road. If railroad construction and operation were new this would be a work of great difficulty. Years of experience in this line of business have unquestionably eliminated many of those difficulties and should have established a sufficient num-

ber of general business principles to make the flotation of such an enterprise a subject of judgment rather than of speculative anticipation. The gross earnings being estimated, we may next inquire into the probable operating expenses, the taxes, and the depreciation charge, and after the respective amounts of these are ascertained, any excess of earnings above their aggregate will represent the sum which is applicable to the payment of fixed charges."

§ 137. (3) Relative Ease in Marketing Stocks or Bonds

When the proportion of earnings applicable to the payment of fixed charges has been determined as above, the complete answer will still be problematical. If the amount ascertained to be so applicable is \$50,000, a bond issue of \$1,000,000 would be warranted at 5 per cent interest; the question then arises whether to issue bonds at 5 per cent to sell at par, or at $4\frac{1}{2}$ per cent to sell a larger issue at a discount. At this point the considerations relating to the effect of market conditions become controlling. The factor of marketability is a complex one and marks the point where the specialized knowledge of the banker or broker must be brought into play. The demand of investors varies from time to time; at one period investors will show preference for one class of securities, and at another period will demand another class. Again, these two classes of securities, stocks and bonds, make their appeal to different groups of investors. It may be generally stated that stock investments appeal more to individual capitalists, large and small, because of the prospect of profits greater than the interest yield upon bonds and the possibility of speculative profits. On the other hand, bonds appeal more to institutions such as savings banks, insurance companies, trust companies, etc., and to persons acting as trustees; they also make a strong appeal to individuals who have only savings to invest and who will not commit their funds to stock investments because of possible uncertainty in payments of

dividends or loss through depreciation of the value of the stock.

The essential point in the question of marketability is the determination of the channels through which and the investors among which the securities are to be placed. If it is expected that the bonds will be sold to ultra-conservative investors such as insurance and savings bank companies, trustees, etc., it is necessary to refer to the laws governing the investments open to such investors. Railroad bonds in the State of New York, in order to become legal investments for savings banks, must be in a proportion not exceeding three times the par value of the total capital stock, while other than domestic railroad companies must have earned gross earnings equaling or exceeding "five times the amount necessary to pay the interest payable during that year upon its entire outstanding indebtedness, and the rentals for said year on all leased lines."

Stock must usually be sold at par; bonds may be sold at a discount so that the effective interest can adjust itself to the prevailing interest rates and market conditions. Bonds may, therefore, under many possible conditions be more readily, quickly, and economically marketed. It is the practice of state commissions in authorizing bond issues to specify the rate of discount at which the bonds shall be sold, and in arriving at this figure they seek to consider the effect of all the conditions and circumstances which will attend the offer of the bonds upon the market.

Part IV.—Capitalization

CHAPTER XIII

PUBLIC REGULATION OF STOCK AND BOND ISSUES

§ 138. Demand for Regulation

Capitalization and capital are very closely related both in theory and in fact, and what are commonly spoken of as problems of capitalization are really problems arising out of the acquisition or disposition of capital. For instance, a confusion between the nature of floating capital and fixed capital may produce the situation of overcapitalization, through the application of the proceeds of long-term securities to floating capital which is quickly consumed and leaves no assets against the liability represented by the securities outstanding. In other words, capitalization cannot be considered as a thing in itself. The purposes of capitalization and the disposition to be made of the proceeds are the important considerations.

Although the general principles of capitalization obtain alike for all corporations, the capitalization of public service corporations has been the most discussed and studied, and it has been subjected to a degree of governmental regulation not attempted in the case of private corporations. The importance assigned to it has been due to the public nature of the operations. There has been a deep-grounded conviction that there is a vital and necessary relationship between the capitalization of these corporations and the rates and charges which they impose. The public has therefore demanded full information

concerning their capitalization, in order to protect itself from supposedly extortionate and unreasonable rates. Color has been lent to this conviction by the great volume of judicial decisions and so-called economic treatises which, in speaking of the return upon investment, have not been clear as to the essential difference between actual investment and par value of stocks and bonds outstanding.

Taking the operations of any company as a whole, there is a very intimate relationship between the capitalization and the rates charged, since the latter should produce a total revenue sufficient to enable the company to meet its interest and dividend obligations, to maintain its corporate credit, and thus give value to the outstanding stocks and bonds. It would, however, be practically impossible to trace the relationship between a part of the service rendered by the company and a part of its capitalization; for instance, the freight rate on a bale of cotton from Dallas, Texas, to New York is in no way comparable with or related to a given number of shares of stock or so many bonds. Then, again, in the case of large public service corporations, railroads for instance, it never happens that all of the tariff schedules are brought under examination in their entirety, and the disconnected regulation of rates to be charged by a company for particular kinds of service or in certain territories makes the influence of capitalization on rates very remote indeed, while in the original computations of these rates, considerations of competitive rates and of the amount which the traffic would stand were controlling, to the exclusion of necessary return upon capitalization.

§ 139. Direct and Indirect Regulation of Capitalization

Public regulation of capitalization may be direct or indirect. It is direct when the consent or determination of a duly established tribunal is necessary to give validity to the issuance of securities, and where that tribunal also exercises some

measure of power to prescribe the conditions under which the securities shall be issued and to direct the disposition of the proceeds. It is indirect when the regulation does not extend to the issue of the securities themselves, but to the operations of the corporation, the establishment of its rates, regulation of operating conditions, or of accounting practice. Indirect control may also be exercised through the enactment of statutes requiring publicity of the incidents of capitalization. While capitalization is not controlling as to rates, rates may be controlling as to capitalization, for they affect earning power and thus influence corporate credit. Any tribunal which has power to regulate rates, such as the Interstate Commerce Commission, has an indirect control over the capitalization as well.

Because of the close relationship between capitalization and capital, the regulation of accounting must naturally be a very potent factor in the control of capitalization, since it will largely determine the disposition of the proceeds of securities issued. A corporation will hesitate to issue \$500,000 in securities to be applied to purposes for which it will be permitted to carry only \$300,000 upon its books as representing permanent assets. Control over the accounts and requirements as to annual and other reports vests a great deal of indirect control in tribunals having those powers. The filing of annual and other reports is generally comprehended in requirements for publicity.

§ 140. Federal Regulation of Capitalization

Direct regulation of capitalization is vested wholly in the several states, each exercising jurisdiction over the corporations organized or operating within its borders. There is no direct federal regulation of capitalization. The Interstate Commerce Commission, however, does exercise a considerable degree of indirect control over corporations doing an interstate business, since it is vested with regulatory authority over

the rates, operating conditions, accounts, and reports of these corporations. The Commission has taken a great deal of interest in problems of capitalization and its decisions contain many references to these problems. It has consistently maintained an agitation for physical valuation of railroads (now under way), claiming it to be necessary, among other things, as an aid in the establishment of rates and the interpretation of facts concerning capitalization and investment.

Through the efforts of the Interstate Commerce Commission and other agencies there has been carried on for many years an agitation to vest in the federal government direct regulatory power over the capitalization of interstate public utilities. The reason for the agitation has been the inefficient regulation on the part of some states, and also the fact that many of these corporations have become so large as to present problems too big for successful disposition by isolated state commissions. Some states make no attempt to regulate capitalization, while others which do attempt it are often met by very serious difficulties because of the interstate character of the properties dealt with. Moreover, those states which have attempted to control capitalization are not at all agreed as to methods and theories. Interstate carriers passing through a number of states must seek the authorization of each one; the facts in the case and the merits of the application will necessarily be alike in all states, but the results achieved will not be uniform. Some years ago the Southern Pacific Company applied to the Railroad Commissions of California and Arizona for approval of a certain issue of securities. The application was granted by the California Commission and denied by the Arizona Commission, with the result that the entire project was defeated. More recently the New York, New Haven and Hartford Railroad Company had arranged for the sale of \$67,000,000 of convertible bonds, part of the issue to be used to refund maturing obligations and the balance to provide needed public facilities. The authorization of

the Rhode Island, Connecticut, and Massachusetts Commissions was sought. The first two authorized the issue but the Massachusetts Commission held that the laws of that state forbade approval. Conflicts such as these, if attributable to differences in law or policy of the different states, emphasize the need for unified control as a necessary expedient to overcome inherent difficulties of state jurisdiction over interstate commerce companies; if not attributable to these causes, the conflicting decisions must indicate that one or the other state is wrong—it erred or is swayed by prejudice, and unification of control becomes desirable to minimize uncertainties of regulation which are due to peculiarities of temperament, inclination, or prejudice of individual commissioners.

The agitation for federal control has received the support not only of many representatives of the public but of many of the interstate corporations as well, the latter hoping that they might thereby be relieved of some part of the ever-increasing burden of piece-meal regulation by state commissions. State courts which have had to deal with the conflicting claims of jurisdiction set forth by state commissions have sometimes expressed a desire for some degree of federal control. The Maryland Court of Appeals in deciding against the Public Service Commission of that state in its claim of complete jurisdiction over a bond issue of the Baltimore and Ohio Railroad Company said:

“It may well be that the time will come when the jurisdiction of the Interstate Commerce Commission will be so broadened as to confer upon it a power to regulate in some measure the fiscal management of the great interstate carriers of this country, and enable them to prevent in the future some of the ill-advised and unfortunate policies of the past.”¹

The attitude of the Interstate Commerce Commission toward the plan of exercising direct federal control of capitaliza-

¹ *M. Laird et al., Public Service Commission v. Baltimore and Ohio R. R. Co.*, 88 Atl. Rep. 348; 47 L. R. A. (N. S.) 1167 (1174).

tion is thus summarized in its opinion upon the New England investigation, devoted primarily to the New York, New Haven and Hartford Railroad:

"In our opinion the following propositions lie at the foundation of all adequate regulation of interstate railroads. . . . No stocks or bonds shall be issued by an interstate railroad except for the purposes sanctioned in the two preceding paragraphs, and none should be issued without the approval of the federal government. . . . That such a measure of regulation is necessary and that it can only be administered through the national government is a necessary conclusion from the facts developed in this proceeding."

In August, 1910, President Taft appointed a Railroad Securities Commission to inquire into the feasibility of the scheme. The report of that Commission, rendered in November, 1911, was adverse to the proposition. It said:

"If we were allowed to substitute exclusive federal control for the jurisdictions of the several states over the railroad corporations, much could be said in behalf of the establishment of a national authority to supervise both the issuance of stocks and bonds and the actual expenditure of their proceeds. But apart from the constitutional clause which might stand in the way of such procedure, the Commission is of the opinion that as a mere matter of expediency the time is not ripe for any such important or enforceable transfer of jurisdiction."

The proposition for federal control has been before Congress continuously for a number of years, with varying measures of success, but no bills have yet been enacted into law. Its advocates received a great deal of encouragement by the hearings before the Newlands Committee of the United States Senate, and there was an excellent prospect of its being enacted into law at an early date, but this has been at least postponed by the recent assumption of operating control over railroads by the federal government. Such bills as have been introduced heretofore have followed closely similar

statutes of the leading states and have not included any important feature which is not to be found in the laws of some state. If federal control is to be a success, however, it must be exclusive and not concurrent with the several states, and it should not be necessary for interstate companies to appeal to both the federal government and the several state governments within whose jurisdiction they may have entered. A most promising change in this respect was the method of federal incorporation so many times urged by former President Taft. This would have substituted federal control over the corporation for state control by permitting interstate corporations to take out federal charters and thereafter become answerable to the sole jurisdiction of the federal government, very much as national banks now are. The idea was not favorably received at the time, but now it is receiving the active support of many who at first condemned it. The tremendous enlargement of federal powers, caused by the Great War, will give impetus to the movement for federal charters.

§ 141. State Regulation of Capitalization

It is only recently that there has been any effective attempt on the part of the several states to regulate by statute the capitalization of public service corporations much beyond the enactment of general provisions that stocks should be issued only "for money, labor done, or property actually received for the use and lawful purposes of the corporations." So far as the issue of bonds was concerned, practically no restrictions were imposed beyond those implied in the grant of the power to borrow money and contract debts "when necessary for the transaction of its business, or the exercise of its corporate rights, privileges, or franchises, or for any other lawful purposes of its incorporation." There have been some other regulatory statutes, enacted in haphazard manner, which have contributed but little, if anything, to the solution of general problems of capitalization.

Effective regulation of capitalization came as an incident of the general state regulation of public utilities. New York in 1907 enacted a Public Service Commissions Law which represented the first attempt to embody in comprehensive statutory form the general principles of regulation; other states soon followed the lead of New York, many of them adopting the statutes with slight modifications, while some others, especially the leading western states, have elaborated considerably thereupon.

The aim and motive of the statutes have been the examination by an independent board of the incidents of proposed capitalization, and the assurance of due publicity of all the facts surrounding the issue. In creating a body to exercise such powers it was necessary that the law should prescribe the limits within which, and the conditions under which, its powers could be exercised. Very wisely the lawmakers, so far as specific provisions concerning capitalization were concerned, placed the emphasis upon the purposes to which the proceeds of the capitalization could be applied and left the details of form and procedure to the discretion of the commissions which they created. In this emphasis upon the purposes of issue lies the most significant departure from the former attempts to regulate capitalization.

Quoting late Interstate Commerce Commissioner Clements: "It may be unwise to attempt to specify the price and the manner in which railroad stocks and securities shall be disposed of, but it is easy and safe to define the purpose for which they may be issued and to confine the expenditure of the money realized to that purpose."

In addition to direct and immediate control over capitalization, state commissions exercise considerable indirect control over the capitalization of both domestic and foreign corporations through the authority to prescribe operating rules and conditions, to pass upon proposed or existing rates for service, to regulate the extension of corporate enterprises

or the entering of new corporations into the field, to regulate accounting, and to enforce publicity.

Where the authorization of a state commission is required, securities issued without the necessary authorization are usually declared by statute to be void, while the issuing corporation is subject to penalties. Penalties also obtain for the diversion of the proceeds of securities to purposes other than those authorized. Personal penalties attach to those who cause the issue of unauthorized securities or who knowingly make false statements or representations in proceedings before the commissions, or who file incorrect statements—acts which some statutes denominate as misdemeanors and others as felonies; the penalty may be fine or imprisonment.

The efficiency of the regulation of capitalization by public service commissions is no longer open to question. Bankers, investors, and economists are all convinced that much good has already been done within the few years that these laws have been in force and within a period which has of necessity included much experimental work.

There is, however, an urgent need that substantial uniformity be brought about between the law and procedure of the several states, so that there may be unanimity of purpose, agreement as to principles, and such a degree of co-operation as will insure due investigation of every phase no matter how much division of authority may be encountered.

§ 142. Limitations of State Jurisdiction

There is considerable confusion concerning the jurisdiction of a state commission over the stock and bond issues of interstate corporations. The first problem is that of jurisdiction over the capitalization of corporations which take their corporate powers in whole or in part from that state, but where the proceeds are to be used outside the state; the second is that of jurisdiction over the capitalization of corporations doing business in that state but chartered by another state.

It is not proposed at this point to enter into a detailed analysis of the statutes and full discussion of legal decisions; a thorough inquiry along those lines would require a volume equal in size to this entire book. It will be sufficient just now merely to suggest certain general principles which seem to be controlling.

§ 143. (1) Jurisdiction Over Stock and Bond Issues of Domestic Corporations

The jurisdiction of the New York Commissions in respect of stock and bond issues extends to those public service corporations which are "organized or existing, or hereafter incorporated, under or by virtue of the laws of the State of New York." Jurisdiction is thus limited to domestic corporations, and concerning these there are no restrictions upon the authority of the commissions by reason of the fact that the proceeds of capitalization are intended to be used outside the state. This is not true, however, of telephone and telegraph corporations which are governed by a somewhat different statute and one that does not distinguish between domestic and foreign corporations, while it does confine jurisdiction to capitalization the proceeds of which are to be used within the state. The statute reads: "A telegraph or telephone corporation may when authorized by order of the commission and not otherwise, issue stock, bonds, notes or other evidence of indebtedness . . . when necessary for the acquisition of property, the construction, completion, extension, or improvement of its facilities or the improvement or maintenance of its service within the state, or for the discharge or lawful refunding of its obligations, or reimbursement of moneys actually expended from the income from any source" The general policy of the New York statute may be said to be that of exercising complete jurisdiction over the capitalization of corporations incorporated pursuant to its laws, no matter where the proceeds of the capitalization are to be expended.

Maryland has a statute very similar to the New York statute and also empowering the Commission of that state to authorize the issue of stocks and bonds by corporations "organized or existing, or hereafter incorporated, under or by virtue of the laws of the State of Maryland." This clause came before the Court of Appeals of that state for construction upon the action of the Commission seeking to enjoin the Baltimore and Ohio Railroad from issuing \$63,250,000 of bonds, convertible into common stock, the proposed issue of which had been theretofore announced by that company but without the authorization of the Commission having been sought.² The position of the Commission was described by the court as follows:

"By reason of the location of the home office of the company in Maryland, it claims to possess a right to control the expenditure of moneys, the creating and issue of evidences of indebtedness, the prices at which such bonds or debentures shall be marketed, the necessity and expediency of the creation of this indebtedness; in general, to direct the entire physical and fiscal policy of one of the great common carriers of this country over its entire system of 4,450 miles of railroad, of which but 281 are within the state and 4,169 located without the state, and one of which other states (West Virginia) might with equal propriety, by reason of the confirmatory act of Virginia of 1827 and the far greater amount of mileage in that state, make a similar claim. The statement of the claim, taken with the terms of the act of 1910, would seem to afford a conclusive answer to the proposition. When the act is carefully limited by its very terms to operations within this state, any line of reasoning which aims to extend it beyond is alike in flat contradiction of the act and entirely beyond the power of the state to adopt."

In saying that the Act was limited "by its very terms to

² *Laird et al. v. Public Service Commission v. Baltimore & Ohio R. R. Co.*, 47 L. R. A. (N. S.) 1167 (1171).

operations within this state," the court had in mind the other sections of the statute which prescribed the general jurisdiction of the Commission as extending to railroads "lying within this state, and to the person or corporation, owning, leasing, operating or controlling the same," etc., and "to any common carrier operating or doing business within the state." These sections also are similar to the New York statute.

The court held that an interstate carrier may be made "subject to the control of each state as to matters affecting the operations of the company in such state, but, beyond that, state legislation is powerless without striking at the very fundamentals of rights as recognized in our government. So far as the issue of securities is concerned, the state may, *by virtue of its police power*, require such applications, reports, and statements to be filed as have a tendency to show whether the proposed issues are bona-fide and for value;³ but the determination of the correct capitalization or bonded indebtedness is a power which was in terms conferred on the Baltimore and Ohio Railroad by its charter . . . and *which the state has not the power to detract from or annul.*"

The last sentence of the above quotation (here italicized for emphasis) suggests a limitation in the specific case then before the court and which was then controlling, thus restricting the usefulness of the decision as a precedent. There are not many public service corporations (except a few of the oldest railroad, bridge, or water corporations) whose charters may not be amended or modified by the incorporating state. When the decision in the Dartmouth College Case (1819) first held that a state could not alter or amend a charter

³ The court apparently upheld the determination of the Circuit Court from which the appeal had been taken and which had held: "It is proper to require the Baltimore and Ohio Railroad Company to file an application or report with the Public Service Commission, stating with reasonable fullness such facts as may be requisite to enable the commission and those legitimately interested therein to ascertain whether any proposed issue or issues of bonds or certificates of indebtedness is or are in fact bona-fide and for value; but beyond that it is not subject to the jurisdiction of said commission as to the financing of the system known as the Baltimore and Ohio Railroad Company, extending through a number of states, either in respect to determining the aggregate amount of capital stock, bonded indebtedness, the prices at which its bonds or certificates of indebtedness shall be sold, or where or how the moneys realized from the sale thereof shall be expended."

already granted by it unless that state had specifically reserved the right so to do, most states promptly enacted statutes or amended their constitutions so as clearly to reserve the right ever after. In 1827 the New York Revised Statutes provided that: "The charter of every corporation, that shall hereafter be granted by the legislature, shall be subject to alteration, suspension and repeal, in the discretion of the legislature." In 1846 a provision of like effect was carried into the Constitution.

Statutes conferring jurisdiction upon commissions group together stocks, bonds, and other evidences of indebtedness as though all of these were subject to identically the same consideration in all cases. The decision of the Maryland court also said: "What has been said already applies equally well to the increase of capital stock or the convertibility of bonds into stock upon stipulated terms and conditions." Stocks, however, are essentially different in nature from bonds and other forms of corporate indebtedness, so that there may, properly enough, be circumstances in which the jurisdiction of a commission will depend upon whether stock or bonds are to be issued.

The authority to issue stock is of the essence of incorporation and it must of necessity come in the first instance from the state which gave incorporation. Stock issued beyond the amount authorized in the charter is void and cannot be legalized by the act of any other state; on the other hand, the issue of stock authorized in the charter will be valid unless the state granting the charter makes some other requirement. If that further requirement is complied with, no other state can render the issue invalid. It would therefore appear, as a general rule, that the state creating the corporation has absolute and exclusive inherent jurisdiction over the issue of stock no matter where or how the proceeds are to be spent. It is, of course, a matter of legislative discretion how much of that inherent jurisdiction shall be actively exercised.

The execution of a bond, whether it be secured by a mortgage or not, and the creation by the corporation of any other claim against itself, must be predicated in the first instance upon the general authority of the corporation to borrow money. Even though the authority to borrow money and incur indebtedness is uniformly regarded as one of the incidental powers of every corporation, the existence of the authority must be ascribed to the grant of charter rights. If that charter, then, is subject to the control of the grantor, the latter may prescribe any reasonable condition for the exercise of any right granted thereby. Hence, it seems correct to hold that jurisdiction over the issue of bonds by any corporation is vested primarily in the state under whose laws it has been incorporated.

The execution of a mortgage to secure bonds is an entirely different proposition. The power to mortgage is closely related to the power to sell, since a mortgage is ineffective unless it carries with it the authority to sell the property to satisfy the demands of mortgagees. Each state has absolute and complete jurisdiction over the ownership and use of property within its borders, and it may regulate or legislate in relation to its acquisition or sale by all classes of corporations. So far as the power to create a lien on property is concerned, each state may grant and control the power to the extent that it affects property within its borders, and while the state creating a corporation may grant authority for the latter to mortgage its properties, that authority can have no extra-territorial force and effect, and the corporation may not plead it as warrant for encumbering its property in another state if that other state chooses to lay down different regulations. The authority to borrow money must come from the state conferring incorporation, in the first instance, but the authority to give security for the loan by way of lien upon realty must come from the state in whose jurisdiction the property is located.

It will be urged that if the state conferring incorporation

can exercise complete jurisdiction over the issue of stock or the borrowing of moneys no matter where the proceeds thereof are to be spent, it will be required to authorize issues for purposes concerning the necessity or cost or other details of which it can have but meager and incomplete information. The final effect of such a situation is bound to be that the law which created and defined the powers of the commission in respect to regulation of capitalization will operate to defeat its own ends. In the mind of the Maryland Court of Appeals whose decision in *Laird v. Baltimore and Ohio Railroad Co.* has been already cited, this difficulty appeared to be a very serious one. "It appears that some or a considerable portion of the moneys to be raised are to be expended beyond the limits of the State of Maryland in the acquisition, extension, improvement or maintenance of the facilities or terminals of the railroad. Manifestly the Public Service Commission of this state is not and could not be invested by the legislature of this state with any supervisory powers over the expenditures of moneys in other states, nor the apportionment of the expenditures of its moneys as between different states, nor could it pass upon, approve, or condemn the wisdom or unwisdom of construction work to be performed in Virginia, West Virginia, Ohio, Indiana, Illinois, Missouri, Delaware, and other states."

The contention is well taken, but it does not affect the question of inherent jurisdiction; rather it exemplifies the defects in the existing systems of divided authority. The solution of the difficulty lies not so much in the limitation of state jurisdiction as it does in the creation of a more comprehensive one, to wit, a federal jurisdiction.

§ 144. (2) Jurisdiction Over Stock and Bond Issues of Foreign Corporations

The whole problem of the constitutional right of a state to control the capitalization of foreign corporations is as fine

a question of law as can be presented; unanimity as to the answer can hardly be hoped for.

A state which seeks to exercise jurisdiction over the capitalization of a foreign corporation must manifestly base its claim upon some ground other than the inherent right to control a creature of its own statutes. Hence that basis must be found in the police power of the state, and the right to control the corporate property or activities in that state. Each state has absolute jurisdiction over the ownership and use of property within its borders, and it also can exercise a considerable degree of regulation over corporations which will submit to its laws for the purpose of doing business within its borders. In a leading case the Supreme Court of the United States described the relation of a state to foreign corporations as follows:

"The corporation being the mere creation of local law, can have no legal existence beyond the limits of the sovereignty where created. . . . The recognition of its existence even by other states, and the enforcement of its contracts made therein, depend purely upon the comity of those states—a comity which is never extended where the existence of the corporation or the exercise of its powers are prejudicial to their interests or repugnant to their policy. Having no absolute right of recognition in other states, but depending for such recognition and the enforcement of its contracts upon their assent, it follows, as a matter of course, that such assent may be granted upon such terms and conditions as those states may think proper to impose. They may exclude the foreign corporation entirely; they may restrict its business to particular localities, or they may exact such security for the performance of its contracts with their citizens as in their judgment will best promote the public interest. The whole matter rests in their discretion."⁴

In its dealings with foreign corporations engaged in inter-

⁴ *Paul v. Virginia*, 8 Wall. 168 (1871).

state commerce, however, the state must observe definite limitations upon its general authority, for "to carry on interstate commerce is not a franchise or a privilege granted by the state; it is a right which every citizen of the United States is entitled to exercise under the Constitution and laws of the United States; and the accession of mere corporate facilities, as a matter of convenience in carrying on their business, cannot have the effect of depriving them of such right, unless Congress should see fit to interpose some contrary regulations on the subject."⁵

A number of states declare their jurisdiction over the capitalization of public service corporations in the following terms: "The power of public utilities to issue stocks, stock certificates, bonds, notes and other evidences of indebtedness, and to create liens on their property, is a special privilege, the right of supervision, the regulation, restriction, and control of which is and shall continue to be vested in the state. Such power shall be exercised by the commission hereby created according to the provisions of this act and under such rules and regulations as the commission may prescribe."

It will be noted that this declaration does not distinguish between the status of domestic or foreign corporations, while it is quite apparent that there must be some difference in the nature, quality, or extent of regulation to which they may be subjected. It then proceeds to include in one general classification stock, bonds, and the power to create liens.

A declaration by the legislature cannot, obviously, operate to confer constitutional authority where that authority has not heretofore existed. This inclusion of provisions such as the above, therefore, does not help to throw any light on the situation, and the states which have enacted these declarations are in no respect placed in a stronger situation than those who, without specific declaration, have proceeded to enact regulating statutes applicable to all classes of corporations without

⁵ *Crutcher v. Kentucky*, 141 U. S. 47 (57).

distinction between domestic and foreign corporations. To declare certain acts to be subject to regulation is, of course, eminently proper, provided, however, they are acts over which the state may exercise jurisdiction by inherent right.

There should first be considered the inclusion of the "power to issue stock and stock certificates" among the "special privileges" subjected to state supervision and regulation. While the state may be permitted to exercise a great degree of regulation over the activities of a foreign corporation operating within its borders, its authority is limited to the acts of the corporation in relation to the corporate operations, and cannot be extended to the organization of the corporation or to those acts which the corporation becomes entitled to perform by virtue of the power which gave it existence. As already pointed out, the issue of stock is of the essence of the corporation and must come from the authorization of the incorporating state; if the latter has not authorized the issue of stock, no other state can grant the required authority; the authority of the incorporating state is inherent and therefore primary, and no other state can exercise a power which will tend to impeach or question the authority of that state.

"A special privilege" is the same thing as a "special franchise." The right to issue stock is a right conferred upon the incorporators who organize and who later compose the corporation; it cannot, therefore, be a "special franchise" of the corporation itself, to wit, a right which may be wholly taken away from the corporation and still leave the corporation itself intact. This being true, it must follow that the authorization to issue stock must come not only primarily but exclusively from the state conferring jurisdiction, and no other state may acquire supplemental jurisdiction.

The power to borrow money and incur indebtedness presents a different problem and one which rests on very debatable ground. The primary authority must come from the incorporating state, but since the power is an essential and

necessary accompaniment of the very authority to engage in business, and a natural incident of the corporation's dealings with others in the regular course of business, it may be argued that it becomes so intimately connected with the general corporate activities as to be within like control as that affecting the operations of the corporation within each state. It would be rash to venture an opinion upon the general proposition, for specific instances may present special considerations which will become controlling. A decision in favor of the authority of each state (other than the one conferring incorporation) to regulate the borrowing of money and the incurring of indebtedness for purposes forming part of the corporate operations in that state will undoubtedly best serve the ends of public policy.

The power to create liens on property is clearly subject to the regulation of the state within whose jurisdiction the property is located. The assumption of authority in this case has nothing whatever to do with the question of jurisdiction over the power to borrow money; it springs out of the unquestioned right to control property located within the state, and the state once acquiring jurisdiction on that basis may proceed to exercise it over every phase of the proposed capitalization. So far as the perfecting of this jurisdiction is concerned, the place where the proceeds are to be spent would appear to be immaterial; even if the proceeds were to be spent wholly outside the state, the authority of the state wherein the property to be encumbered is located would nevertheless continue to be essential. In this respect statutes similar to those of New York relating to telegraph and telephone corporations, and which take expenditures within or without the state as the test of jurisdiction, are perhaps defective.

CHAPTER XIV

THE TASK OF PUBLIC SERVICE COMMISSIONS IN REGULATING CAPITALIZATION

§ 145. Statutory Purposes for Which Capitalization May Be Authorized

The Public Service Commissions Law of New York provides that a corporation subject thereto may, under the authority of the Commission, "issue stocks, bonds, notes or other evidences of indebtedness payable at periods of more than twelve months after the date thereof, when necessary for the—

1. Acquisition of property,
2. Construction, completion, extension or improvement of its facilities (railroad, telephone, and telegraph), and of its plant or distributing system (gas or electric),
3. Improvement or maintenance of its service,
4. Discharge or lawful refunding of its obligations,
5. Reimbursement of moneys actually expended from income." ¹

The order of the Commission must state "the purposes to which the issue or proceeds thereof are to be applied, and that, in the opinion of the Commission, the money, property or labor to be procured or paid for by the issue of such stock, bonds, notes or other evidence of indebtedness is or has been reasonably required for the purposes specified in the order."

The statutes of many other states are very similar to that of New York in the enumeration of purposes to which the

¹ Words in parentheses not found in the law.

proceeds of capitalization may be applied; some states have substituted or added more general purposes, while a few have attempted greater detail. A comprehensive analysis of all the statutes on the subject is impracticable, hence the discussion here is confined largely to the New York statute which is fairly typical. In the following chapters are discussed the general principles governing capitalization for each of the purposes above described.

In its first annual report the Second District Commission described the enumeration of purposes in the statute as being "exclusive and not inclusive; that stocks and bonds may not be issued for purposes not enumerated in the statute, either with or without the authority of the Commission." The early decisions of that Commission indicated some doubts as to the sufficiency of the enumerated purposes; the Commission once expressed the opinion, reached "after full discussion," that "power should be given to it to authorize the issue of stock, bonds and other evidence of indebtedness for some corporate purposes not now enumerated. . . . We are constrained to believe that the section could be made more comprehensive without danger to the spirit of the law and with benefit to proper corporate operations."¹ There was no intimation of what other purposes the Commission would have included, while in a case decided later it apparently went on record as approving of the sufficiency of the corporate purposes enumerated in the statute, saying:

"If the company, upon its application for the consent of the Commission, can point out that it desires to use the money for one of the purposes specified in the statute, that consent will, of course, be given in a proper case. If it has expended, previously, money from its treasury which would entitle the bonds from the trustee, of course it can obtain them by reason of that fact. The statute simply limits to some extent the purposes for which the money derived from the sale of such

¹ *Matter of Erie R. R. Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 115 (126).

bonds can be applied. If it desires to use the money for the acquisition of property; for the discharge or lawful refunding of its obligations, or for the extending or improving of its facilities, or improving or maintaining its service, it can do so, and practically the only other purpose for which it could wish to use the money would be to declare dividends. Corporations can easily adjust themselves to this statute, and it is apprehended no embarrassment need be expected in its operation.”⁸

That the purposes enumerated have been sufficient for all proper purposes of corporate financing has since been demonstrated by the fact that during more than ten years of its operation there has been no serious attempt to amend the law in this respect, while the absence of complaints has indicated that corporations have not suffered material hardship in adapting their practices to the statute.

§ 146. Scope of Commission's Authority

Financing, whether public or private, is a thing which demands considerable elasticity; it may be regulated, but it must not be fettered. Corporate financing in order to be successful must take advantage of opportunities, be free to bargain, ready to respond to favorable influences and to adopt expedients if unfavorable circumstances prevail.

Hence, if the state is to regulate financing, it must also co-operate. The commission charged with authority may at times be required to use that authority as veto power, to prevent or prohibit; but most often it must exercise it in open co-operation. The function of regulating laws, therefore, can best be that of declaring the policy and purpose of the state, and of prescribing the limits, made sufficiently wide, within which those charged with the administration of the laws may work with those engaged in financing, sharing in common the purpose of maintaining the integrity of invested capital, in-

⁸ *Lehigh & Hudson River R. R. Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 224 (231).

viting new capital on reasonable terms, and in general to assure the continuance and adequate expansion of the facilities for public service.

§ 147. (1) Application of the Statute

The New York Public Service Commission for the Second District thus describes the intent, in retrospect as well as in prospect, of the statute under which it works:

"Money to be acquired from the sale of stocks, bonds, or other evidence of indebtedness, payable at a period of more than twelve months after the date thereof, is money secured by capitalization, and the spirit of the act is to control capitalization; to see that it is made only for certain legitimate purposes, and then only to an amount that is necessary for the reasonable accomplishment of such purposes; . . . to restrain and limit the hitherto irresponsible elasticity of corporate capitalization to the matters which may properly be capitalized." ⁴

The Court of Appeals of New York in the first important case brought before it in respect of the regulation of capitalization, described the same statute as follows:

"The paramount purpose of the enactment of the Public Service Commissions Law was the protection and enforcement of the rights of the public. . . . For a generation or more the public has been frequently imposed upon by the issues of stocks and bonds of public service corporations for improper purposes, without actual consideration therefor, by company officers seeking to enrich themselves at the expense of innocent and confiding investors. One of the legislative purposes in the enactment of this statute was to correct this evil by enabling the commission to prevent the issue of such stock and bonds, if upon an investigation of the facts it is found that they were not for the purposes of the corporation enumerated by the statute and reasonably required therefor. . . . It was

⁴ Lehigh & Hudson River R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 224 (229, 232).

designed to make the commissioners the guardians of the public by enabling them to prevent the issue of stock and bonds for other than the statutory purposes."⁵

The statute quoted is very general in its terms; there is no attempt to describe in detail the class or kind of property which may be acquired, to prescribe a rule for the determination of value for capitalization purposes, or to enumerate and define the costs properly includible in "construction, completion, extension or improvement of its facilities," and in "improvement or maintenance of its service." What the statute prescribes is, "first, that capital shall be secured by the issue; second, that the issue of such stock, bonds, or other evidence of indebtedness is necessary to obtain such capital for one or more of the four purposes⁶ enumerated in this section; third, that the amount authorized is reasonably required for one or more of such purposes. When any one of these elements is lacking in an important case the Commission has no right to issue an order authorizing the desired issue."⁷

§ 148. (2) Incidents of Capitalization to Be Considered by Commission

The statute suggests the principle, and requires the Commission to work out the details. Because of the great latitude allowed these commissioners for the exercise of sound discretion and judgment, the careful study of the record which they have made becomes very important for those who desire to know just what limitations are to be imposed.

"The provisions of the law regulating capitalization of public service corporations are general in terms and are designed to embrace cases of all classes, those presenting difficult conditions and pressing necessity as well as those relating simply to the refunding of prior liens or the raising of capital

⁵ People *ex rel.* Delaware & Hudson Co. v. Stevens, 197 N. Y. 1.

⁶ The fifth purpose, i.e., reimbursement of income, is disregarded because it relates to expenditures which have already been made.

⁷ Matter of Erie R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 115 (120).

for the acquisition of property or for improvements by the sale of bonds which are marketable at or near par value. Upon all cases of capitalization the law intends that the Commission shall act with comprehensive knowledge of the financial, physical, operating and traffic conditions pertaining to the property sought to be charged with new capital, and that permission to raise new capital shall be granted in those cases where the kind of bonds, the security upon which they are based, the terms of proposed sale or exchange, the stated disposition of proceeds, the financial condition of the applicant, its resources, traffic and otherwise, and, generally, the state of its property, are such as, in the belief of the Commission, warrant certification that the capital sought to be secured by the proposed . . . issue is reasonably required specifically for one or more of the purposes named in the statute as the basis of future capitalization.”⁸

Most of the considerations described in the last part of this quotation are to be found in the statute only by implication, while others represent questions bearing upon the exercise of discretionary powers by the Commission. A correct determination as to these is not only of collateral importance but really very essential to the proper disposition of the case in its entirety. Very early in its work the Second District Commission took occasion to announce that in passing upon an application it would consider:

- “1. The purposes to which the proceeds arising from the sale of the securities are to be applied.
2. The amount reasonably necessary for the consummation of such purposes.
3. The character of the securities proposed to be issued.
4. Whether any proposed construction or extension is likely to create unhealthful conditions or otherwise constitute a public nuisance, infringe upon the vested rights or impede the necessary operations of

⁸ Matter of Erie R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 471 (487-488).

other public service corporations, or interfere with the flow of water in a navigable stream to the extent of impairing its public use.

5. Whether there is any reasonable prospect of a fair return upon the investment proposed, to the end that securities having apparent worth but actually little or no value may not be issued with our sanction."⁹

This list does not exhaust the possible considerations, for every important case will bring its own individual problems. In the words of the New Jersey Court of Appeals, it is the Commission's duty to investigate not only the object of the proposed issue "but the conditions under which it is to be made, and the entire environment of the company with its antecedents, and the prospective opportunities it may encounter in view of its past history, to meet the financial demands that the proposed burden is likely to impose upon it"; in other words, to pass upon "not only the legality of the financial proposition advanced, but upon the very merits of the subject matter itself from the standpoint of a wise public policy."¹⁰

§ 149. (3) Limitations Upon Discretionary Powers of Commission

While a great deal of discretionary power must and has been allowed to commissions, there must also be some point where the grant of authorization may be demanded as a matter of right. The statutes do not deny to corporations the right to issue stocks and bonds; they prescribe the purposes for which and the conditions under which stocks and bonds may be issued, and if an applicant proves compliance with the law, it becomes entitled to an order authorizing the issue. Court decisions in New York and elsewhere are in harmony on this

⁹ *Matter of Hudson River Elec. Pwr. Corp.*, 1 P. S. C. Rep. (2nd D., N. Y.) 51 (67).

¹⁰ *Interstate Tel. & Tel. Co. v. Public Utility Comrs.*, 84 N. J. L. Rep. 184; 86 Atl. Rep. 363.

point. The Indiana Supreme Court construes the statute ¹¹ of that state as follows:

"From the provisions of this act it is apparent that the Public Service Commission is required to hear and determine the facts upon which the application is based, and the facts thus determined constitute the foundation upon which its order shall be based. If the facts thus found are such as to entitle the utility to a certificate of authority to issue and sell bonds in a given amount, it is the duty of the Commission to issue such a certificate. Under such circumstances the act required is ministerial and not discretionary. To hold that such act is discretionary would enable the Commission, after the facts were determined, to grant the certificate of authority or to withhold it at its will, or to grant such a certificate to one public utility and to withhold it from another under the same state of facts. . . . A duty is none the less ministerial because the person who is required to perform it may have to satisfy himself of the existence of a state of facts under which he is given his right or warrant to perform the required duty." ¹²

The Public Service Commission of Indiana, referring to its own powers under that statute, states:

"We assume it to be fundamental that the legislature could not, and has not attempted to, grant to this Commission legislative powers; and, further, that the arbitrary determination that stocks and bonds may or may not be issued is the exercise of legislative power, and any law which attempted to place in the hands of this Commission such arbitrary authority would be unconstitutional. The law creating the Public Service Commission of the State of Indiana stipulates when and for what purposes a public utility corporation may issue stock

¹¹ The statute reads: "If the Commission shall determine that such proposed issue complies with the provisions of this Act, such authority shall thereupon be granted, and it shall issue to the public utility a certificate of authority."

¹² Public Service Com. v. State *ex rel* Merchants Heat & Light Co., 184 Ind. Rep. 273 (280).

or bonds, setting out in detail the necessary conditions that must exist before such stock or bonds may be issued, and then casts upon its Commission the burden and duty of conducting an investigation to determine the fact or facts in each case, and then provides that if the facts which the legislature provided must exist do exist, the authority shall be granted.”¹³

There is danger, however, of formulating too narrow a conception of a commission's authority. The prevailing rule can be stated to be that a corporation will become entitled to the execution of a certificate authorizing the issue of the proposed stock and bonds if that proposition is brought within the terms of the statute. The commission must then execute such a certificate unless it can set forth facts which prove the proposed issue to be against public policy or which operate to estop the corporation from demanding the execution of a certificate as a matter of right. The commission must approve or disapprove of the proposition as presented to it or as amended by the applicant in accordance with suggestions of the commission. It may not, however, order the issue of any more stocks or bonds, or in any different proportion, or for any other purpose, or prescribe any other act the authorization of which must come in the first instance from the directors or stockholders of the corporation.

§ 150. Problem of Existing Overcapitalization

There are many corporations whose present finances reflect the effects of practices which were essentially vicious or which have since come to be regarded as improper. The situation of these corporations presents a difficult problem to public service commissions. Are these commissions called upon to bring the outstanding capitalization of such corporations into conformity with the principles which they establish or apply to capitalization that they authorize for issue? Must a commission seek to remedy the past no matter how drastic the

¹³ *In re Farmers & Merchants Co-op. Tel. Co.*, P. U. R. 1915-B, 55 (37).

measures of correction required for such purpose? Or, being unable to remedy the past, should a commission refuse to consider an application for the issue of additional stocks and bonds by a corporation whose present financial condition is the result of past improper capitalization? Regulation would become prohibition, if that were done. Shall it not, then, turn away from the past and grant or refuse to grant authority wholly upon a consideration of the legality, necessity, and propriety of the present proposed issue?

There is no unanimity in the answers to the above queries. How far the powers and authority of a commission can be said to be retroactive has been a perplexing question. These commissions were created to correct abuses well defined, and ample powers have been given them to that end. There are differences of methods used in the correction of human beings who have erred in their ways; some need the knife of a surgeon to remedy a physical defect, others need instruction; most of them need changed environment and encouragement to act aright. There are also differences in the methods of correcting corporations that suffer from past maladministration.

§ 151. (1) Extent to Which Regulation May Be Retroactive

The abuse most often brought forward is overcapitalization. Undoubtedly it never was intended to make statutes retroactive to the extent of conferring power upon any commission to order the present capitalization of a corporation to be pared down, simply because it does not approve of the circumstances and conditions under which the stocks and bonds, or some of them, were originally issued, or else because it considers the present value of the assets to be less than the par value of the capitalization outstanding. People will be found, however, who assume that this is precisely what the commission ought to do; such people must have pressed their theories upon the Railroad Securities Commission, causing it to make a very emphatic statement on the subject:

"An attempt to scale down old securities is clearly out of the question. Apart from the obvious constitutional difficulties of such a course, considerations of public expediency of themselves forbid it. The direct loss over the unsettlement of legal and equitable relations would be very great. The indirect loss from the withdrawal of confidence in American railroad investments would be immeasurable. Such a readjustment would become archaic almost from the outset, because an adjustment of securities based upon the values of today might be totally erroneous tomorrow. It would be equally inadvisable, in cases where outstanding securities were in excess of the physical valuation, to prohibit the issue of new securities until physical value had become equal to the amount of securities outstanding; because this principle, if generally applied, would prevent roads so situated from securing the capital needed for the service of the community."

The reference to constitutional difficulties probably relates to the provisions of the Federal Constitution prohibiting the states from passing laws or committing acts to impair the obligations of existing contracts; obviously it would be impossible to remedy past abuses of capitalization in the manner described without jeopardizing the legal and contractual relationships of shareholders, bondholders, general creditors, or of some of them. The Federal Constitution imposes no such restriction upon the power of the national government and federal legislation would not be subject to this limitation; but even though constitutional prohibitions fail to restrict exercise of this power, undoubtedly considerations of economic and commercial expediency would be found to be just as restrictive as constitutional prohibitions in state regulation.

§ 152. (2) Nature of Overcapitalization

In discussing overcapitalization it is necessary to hold closely to definitions. Overcapitalization as a term means simply that the capitalization is greater than it should be, but

the thing with which it is compared in arriving at the conclusion concerning its excess is not alike in all minds. Some compare it with the consideration actually received upon issue, others with the value which should have been placed upon that consideration in place of the value which was actually placed. Very frequently it is compared with the present value of the subsisting assets, and not infrequently people will be found to charge overcapitalization solely on the ground that the earnings distributed as dividends on the stock are not as great as they think they ought to be.

The connection in which the term is used may sometimes indicate the specific meaning ascribed to it. For instance, if the property is spoken of as being overcapitalized, the meaning should be that there is outstanding an amount of stocks and bonds greater than that which the value of the property owned by the corporation warrants. If it is the enterprise or the company which is spoken of as overcapitalized, the meaning should be that the amount of outstanding capitalization is greater than the earnings warrant. It will be noted that this last situation may also exist where the actual investment has been greater than necessary and where a smaller investment would have produced the same amount of earnings.

It is not sufficiently understood that it makes a great deal of difference whether the overcapitalization is based upon the amount of stock and bonds together, or upon the amount of the one or the other alone. Overcapitalization, so far as it represents a danger in and of itself, wholly apart from the fact that it may be made the means of misrepresentation in the hands of unscrupulous people, is a device of inflated credit; that is to say, its existence will signify that there is outstanding an aggregate claim against wealth which is greater than the wealth itself. Bonds and other forms of indebtedness represent a claim against wealth; capital stock is evidence of possession of the wealth.

Take the case of a corporation which is making its original

issue of capital stock, no bonds being utilized in the financing. If it sells the stock at par, each share will represent an interest of value equal to the par; if the stock is sold at a discount, each share will represent a value which is simply a proportionate amount of the aggregate amount received from the sale of the stock; if it is issued in exchange for property, each share will represent a proportionate part of the value of that property whatever that value is found to be. Let some time elapse, and take the same company's situation; its capital stock represents simply the value of the existing assets. A discrepancy will be found only if one compares the par value with the actual value of the stock, but why should this confusion of the nature of things cause a charge of defective financing against the corporation?

The trouble, of course, lies in the fact that because of the par value expressed or for other reasons, people will be found who will place a value upon the shares of stock in excess of real value, and will give or advance money on the shares accordingly; thus, indirectly, there will be created claims against wealth exceeding in amount the value of the wealth. The corporation, however, is not a party to the transaction, although it may be indirectly responsible if the misrepresentation of value arises from an incorrect or exaggerated statement of its financial situation.

Suppose this same corporation finances its project out of the issue of bonds, giving the stock as bonus. Obviously the stock has no value because it does not evidence the possession of wealth. If, moreover, in consideration for the issue, property other than cash was accepted at an overvaluation, overcapitalization must result. Or, again, even if the issue had been made for full value and thereafter continued operations at a loss have caused the capital to be impaired, overcapitalization will likewise result. But take the more usual situation where both bonds and stock are issued, each for substantial consideration, and unprofitable operations thereafter impair

the capital: overcapitalization will not result as long as the capital stock alone can absorb the loss. Not until after the stockholders' equity has been completely wiped out will there arise the situation of outstanding claims against wealth exceeding in amount the wealth itself.

As long as the stockholders continue to have any equity at all, a charge of overcapitalization must mean that the par value of the outstanding stock is greater than the value of the equity. Of what use can it be to make an adjustment of the outstanding capitalization so that the value of the outstanding shares may equal par? Moreover, how is the value of the equity to be measured, in view of the difficulties described elsewhere (§ 168) as standing in the way of placing a value upon the capital utilized in a public service business? Even if a value were arrived at, how could it be thereafter maintained? The most serviceable measure of value is that which reflects the earning power, and earning power is usually the measure of corporate credit as well.

§ 153. (3) Regulation of Accounts a Corrective Measure

Under the circumstances stated above, to what extent should a commission seek to remedy alleged overcapitalization? It was noted that the corporation becomes indirectly responsible for some of the evils resulting from misrepresentation of real value of the stock if the misstatement of its own accounts causes that misrepresentation. To a great extent, then, the evils of alleged overcapitalization can be corrected through regulation of the accounts. If the assets are insufficient to take care of the liabilities, the accounts will show it; if dividends have been improperly distributed, if stocks and bonds have been issued for other than proper purposes or for inadequate consideration, the accounts should reflect the situation if they have been properly kept. The state commissions, and the Interstate Commerce Commission as well, have been given very broad powers in regulating accounts and in en-

forcing a true statement of the financial affairs of the corporations under their jurisdiction. In the control over the accounts, therefore, the commission has one very effective method of satisfying all proper public demands in this respect. If more drastic correction is required, it should be achieved through means and under legislation other than those relating to the powers of these commissions. The question of retroactive effect of commission orders is not involved; an order that the accounts be written and facts properly set forth will, of course, relate to the statement of past transactions, but it will represent a very proper exercise of the commission's powers. And yet, here also the commission must consider its obligation to protect established credits; if the net effect of rewriting the accounts will be to place in jeopardy the continuance of the corporate enterprise and its legitimate extension, justice must be tempered with mercy. An understanding may be reached as to accounting procedure which will in due course of time and without undue disturbance rectify the errors of the past. It goes without saying that the corporation must show absolute good faith both in collecting the facts of past transactions and in willingness to correct the mistakes.

An examination of the accounts must be very thorough if orders for rewriting are to be based thereupon. Such an examination will necessarily involve considerable expense and much of the time both of experts employed by the commission and of the commissioners themselves, as well as of the corporation's staff. Hence, although the commission always has the power to order an examination, such a task is seldom undertaken unless the issue is specifically raised. It is sometimes done in rate cases, but more often in the consideration of applications for authority to issue additional stocks and bonds. The commission may then insist that the accounts be corrected before authorization is granted, so that the public may have an accurate statement from which to draw its conclusions as to the value of the securities which it shall author-

ize. A situation requiring such disposition was described by the New York Commission as follows:

"This company seeks to obtain money by the sale of bonds and stock at a time when its accounts are untrue to a very large and material amount. The value of such stock and bonds is in very great measure to be determined by the truthfulness of those accounts. No one can determine whether to invest in these securities without relying upon those accounts. Knowing the facts, it would be impossible for the Commission to justify itself in allowing these securities to be placed upon the market to be sold upon the faith which the buyer must repose in the correctness of the company's balance sheet."¹⁴

The Commission in this case is not seeking justification for withholding consent to the issue of additional securities on the ground that overcapitalization is apparent, but rather that the accounts are incorrect, and that the corporation, if it did not amend its accounts prior to the issue of additional securities, would be presenting to the possible investor a false statement of its assets and liabilities, that is to say, it would misrepresent its credit. Even in such a case as this, however, the problem cannot be solved by merely withholding consent, for the situation may be such as to call for affirmative action if the business is to be continued. Regulation, if it is to be worth while and successful, must be a positive, not always a negative, force; it must be permissive as well as restrictive.

§ 154. (4) Overcapitalization Need Not Bar Proper Stock and Bond Issues

There are, of course, cases where overcapitalization has been wilful, caused by the acceptance of property at an overvaluation or the issue of securities for inadequate consideration. Such transactions, however, have been carried out under color of the law; for instance, pursuant to the statutory declaration

¹⁴ Matter of Binghamton Light, Heat & Power Co., 2 P. S. C. Rep. (2nd D., N. Y.) 171 (202).

that the judgment of the directors as to the value of property received shall be conclusive. To question these acts long after their occurrence, or to base formal action concerning pending application upon a judgment as to the impropriety of these transactions, would be a dangerous exercise of authority.

The effect of statutory requirements limiting capitalization to certain ratios of assets, such as the Texas statute which limits the issue of stocks and bonds "at no time to be more than 50 per cent over the value of the whole property and franchises," is to hold the Commission to the strict rule that additional capitalization may be authorized only where the entire authorized capitalization (i.e., that already outstanding and that to be issued) bears a proper relation to the value of all the properties then possessed or to be acquired through the proceeds of the new issues. The experience of that state under this statute has not been such as to invite other states to the enactment of similar statutes.

Very early in its work the New York Public Service Commission for the Second District had to consider an application for the issue of additional securities, which was being opposed by city officials upon the ground that the company was already very much overcapitalized, in proof or disproof of which assertion they asked for a careful valuation of the property of the corporation. This request of the city was denied by the Commission, which announced that it would not inquire into any alleged overcapitalization and that its investigation into the merits of the company's application would be confined "to the question whether such capitalization should be authorized by reason of the actual investment of money for the purposes of the corporation recognized by law as a subject of capitalization." It said: "The question as to the possible overcapitalization of the company is an interesting one; but it does not seem to the Commission to have any direct bearing upon the application before it." Moreover—

"To hold up needed improvements in a case like this, while

the exact condition of the corporation is investigated and the value of its capitalization determined, would be undesirable. The Commission might become involved in endless complications which would tend to defeat the very purpose of its existence; and improvements needed for the efficiency of public service might be held up, while the facts as to a matter were ascertained which, however interesting and valuable in themselves, would not help the Commission in the least as to deciding the point at issue. The past of a corporation, whether financially faulty or blameless, should not bar the way to its rendering efficient service in the present or future."¹⁵

§ 155. Financial Record and Status of Applicant to Be Considered

While the Commission will not pass upon overcapitalization alleged to exist because of discrepancy between the value of the existing assets and the outstanding stocks and bonds, the financial record of a corporation seeking additional capital is a matter on which the Commission is bound fully to inform itself, especially where the corporation has not always been subject to regulation. There is described elsewhere (see Chapter XVI) the not uncommon expedient of issuing additional securities to purchase equipment or other items of fixed capital for the replacement of units which have been retired but which continue to be carried in the accounts as though still in service. The purpose is very evident; since the liabilities would be increased by the amount of the new issue, it is necessary to increase the assets also by the amount of the new capital acquired, which will therefore be shown as an addition, while actually the assets were not increased at all, or perhaps increased only by the difference between the cost of the old and the new capital. In these instances only the most careful investigation will reveal the fact that securities proposed to be issued ostensibly for proper corporate purposes are in reality

¹⁵ Matter of Watertown Light & Power Co., 1 P. S. C. Rep. (2nd D., N. Y.) 146 (1955).

to reimburse the corporation for operating expenses—a very improper purpose and clearly effecting gross overcapitalization.

Moreover, the financial record of an applicant will prove a valuable index to the character, ideals, and efficiency of the management, on which there may be based an estimate as to the probable success of a new venture. It may also prove decisive as to the character of the securities to be issued; it may be that the proportion of bonds to stock is too great and the proposed financing should be confined to capital stock issues to restore the bondholders' margin of security and to hold down fixed charges so as to lessen the possibility of such financial embarrassment as has very often been the source of temptation for much of the corporate "high finance." Or, again, it may be that on the basis of that record future financing will be limited to temporary expedients until, by a process of withholding dividends and putting earnings back into the property, the corporation re-establishes its credit so that long-term securities may be issued without the necessity of heavy discounts or extra-high rates of interest.

It will not be possible, neither would it be desirable, always to require a thorough inquiry into all the details of past financial practices, the state of the accounts, and the condition of corporate affairs. Every commission will at times face limitations upon time and capacity which will be controlling, and to adopt a rule that such procedure must be followed in every case would work hardship in many instances where the need for new capital is pressing and imperative. The purposes of the proposed issue, the relative increase to be effected in total capitalization, and other incidents of the application before the commission, will have to be considered in passing upon the need for such a thorough inquiry.

§ 156. Paramount Duty of Commission

It must never be forgotten that the greatest responsibility of a commission in the exercise of its regulative powers is

that of assuring the continuity of the service rendered by the public utilities. The commission may become interested in the consideration of the moral niceties of past transactions, it may be convinced of imprudence, mismanagement, inexperienced financing or what not, as indicated by the record before it. The real question which must be determined, however, is how best to assure the continuity of the enterprise, considering its history and its conditions and needs. If the historical record of each corporation were to be arbitrarily used against it, many public utilities would find all doors for expansion and growth, and every possibility of living down the past, as it were, closed before them. The only alternative open to them would be that of dragging along with poor facilities and increasingly poor service, or going into bankruptcy. The first situation is highly undesirable from every standpoint; the second is inequitable in that it penalizes the present security holders for all the mistakes, innocent or wilful, of the past owners by taking the property out of their hands and transferring it to others at the low cost necessarily involved in a forced sale under such conditions, while giving the new owners complete freedom in financing the improvement and expansion of their plant to render operations more profitable. It must not be forgotten that practices which today may be considered improper, may at the time of their use have been considered as being eminently proper and expedient to a compelling degree. In the pioneer days of many classes of public utilities a great many matters which today are subject to rule and classification were then merely matters of guess and experiment. Each man's guess was different from that of all others; each had his own theory and carried on his own experiments.

It is just such a situation as that described above which was referred to by Mr. Hemans of the Michigan Commission in discussing before the National Association of Railway Commissioners ¹⁶ a committee report which had expressed the

¹⁶ Proceedings of 1913 Convention, page 238.

relative desirability of corporate bankruptcy as against the abandonment of the strict theory that the present situation of a corporation and its record should be conclusive against an application to issue additional stocks and bonds:

"If the report of the Committee means to say that it is bad practice, under all conditions and circumstances, to allow a utility which has become indebted over and above the amount of its stock and bonds to issue further securities, I do not wish, by my silence, to seem to acquiesce in that proposition. . . . I submit that there are conditions under which a commission is justified in allowing the issuance of securities under such circumstances.

"I quite heartily agree with the Chairman of the Committee when he says that the public is not interested in the question as to who furnishes the service. That is very true; but when that service has been the result of the best knowledge possessed by the organization under all the circumstances, and a loss has developed through an inadequate rate because of a lack of knowledge of the conditions that should apply, or when that loss has resulted through an inefficient and destructive competition, or through stress of financial conditions over which the utility has no control, then I submit that the Commission of which I am a member would feel justified in allowing that utility, which has been honestly and efficiently conducted, to sell its securities if possible. In other words, I believe that instead of a hard and fast rule, which I understand the committee to recommend, the only rule that can be enforced in practical affairs is the rule of the exercise of a wise discretion.

"The Michigan law provides that the Commission shall find that the securities are reasonably required for the purposes of the organization, and under that broad grant of power the Michigan Railroad Commission attempts to say what is reasonable in each particular case; and we submit that you cannot make a hard and fast rule, and say that every utility which by

stress of conditions that could not be foreseen has, in a measure, impaired the capital, should go into the hands of a receiver. It is true that the consumer is not interested in the question, who furnishes the service; but, so long as we believe in the private ownership of utilities, so long as we invite the investment of capital to furnish the utilities that the public enjoy, while the public may not be interested in the question, who furnishes the service, I insist that the public are vitally interested in the integrity of the investment of the man who puts his money in and risks the conditions that may overcome the utility.

"Thirty years ago men invested their money in the telephone utilities, with no one to blaze the pathway over which they were to travel. They did not know the amount that should be charged for depreciation. They did not know what were adequate rates; and many a corporation was near to bankruptcy because it was traveling an unknown path. I submit that it is the part of wisdom, if conditions of that kind are repeated, and a loss is brought about, because of conditions over which the men who have acted honestly and as efficiently as they knew how have had no control, it is the part of wisdom for the Commission to allow a utility corporation, under such circumstances, to issue further securities. I think the Commission should be governed by a wise discretion."

It goes without saying that above all things the commission must exercise the greatest care to base its own acts and authorization on absolutely sound principles, and then to see that its orders are faithfully carried out, so that the corporations growing up under its guidance and protection may be kept free of corruption and saved from the abuses and mistakes which have heretofore jeopardized many public service corporations.

CHAPTER XV

COLLATERAL ASPECTS OF REGULATING STOCK AND BOND ISSUES

An enumeration of the matters within the jurisdiction of the public service commissions was given in Chapter II, and it was there explained that in studying the regulation of capitalization it would be necessary to give some attention to other aspects of regulation because of their intimate connection with the subject in hand. Some of these have been touched upon incidentally in the foregoing pages, and this chapter takes up a brief discussion of the more important matters of collateral interest.

§ 157. Control Over New Enterprises

The existence in one community of two or more public utilities means the duplication of plant and the division of business. Each must construct its own plant, erect its own pole lines, lay down its own conduits, and undertake whatever other construction may be needed to carry on its enterprise; each at best will get only a portion of the business which the community can give. In other words, the capital invested is multiplied while the volume of business in the community remains the same. Such competition will not long prevail between two companies; it will not be long before they will find it to their interest and advantage to merge their separate enterprises. The merger, however, while rendering possible a unification of the operations, cannot restore to the investors the capital committed to an unnecessary plant.

To prevent the preliminary stage of ruinous competition and to lend stability to the enterprises which have become

established, public policy demands that regulating commissions shall have the power to guarantee to corporations freedom from competition so long as these corporations adequately serve the public and meet the requirements imposed upon them.

Chapter II described how state governments introduced unrestrained incorporation and free competition, by abandoning the system of incorporation by special act, without at the same time providing any other method of control over new corporations; also how the disastrous effects of rate wars and irresponsible competition forced the states later on to reassert some measure of regulation, mainly through boards of railroad commissioners. When the New York Board of Railroad Commissioners was first organized in 1883 it could exercise no control whatever over the entrance of new corporations into the field, while the general corporation laws continued to extend the great measure of latitude in this respect which had prevailed since 1850. In its first annual report this Commission said:

"It is the general opinion that the time has now come when the State ought to supervise such proceedings" (i.e., those preliminary to incorporation) "and more carefully exact compliance with preliminary conditions, as well as to insist that before the right of eminent domain is vested in a railroad corporation there shall exist a reasonable public demand and necessity for the road proposed to be constructed."

In its next annual report (1884) the Board described the following very interesting situation:

"A war of rates has broken out, of which at this writing no one can see the outcome. It looks as if the struggle for existence had begun, of which the result will be the survival of the fittest, the financial death of others, with its attendant distress and loss of property. In the month of June the New York, West Shore and Buffalo Railway Company went into the hands of a receiver. . . . The receivers of the property

being under obligations alone to earn operating expenses, and with the hope of increasing the business by a radical reduction, about the 20th of October reduced the rates to the unprecedented figure of one cent per mile for the transportation of passengers. A corresponding reduction was made in freight charges. These rates have been met by the New York Central and Hudson River Railroad Company. It is needless to dwell upon the demoralization, fluctuations, and loss incident to such a condition of affairs as the above.

"It is urged that one lesson to be drawn is the lack of wisdom on the part of the State of permitting any thirteen men who can secure subscriptions of \$10,000 per mile, with ten per cent thereof paid in, to build a railroad anywhere they see fit without an expression from the State of the public exigency for the same.

"A railroad cannot be built without the State delegating to its promoters the highest power it possesses over property: the right of eminent domain; the right to take private property for public uses. The State itself never exercises this sovereign power except in cases of *public necessity*. Why should it thus delegate it to any thirteen men to be exercised for mere private gain, frequently at the expense of vested rights and grave public interests?

"When the State has undertaken the control of railroads by the creation of supervisory boards, and has determined to exact the highest standard of service at reasonable rates of freight and fare, it would certainly seem as if a corresponding obligation rested upon it to protect existing railroads from useless and disastrous competition by unnecessary new ones. It was, with these ideas in view, that the majority of the Board made the recommendation for the amendment of section 2, chapter 140, of the laws of 1850, in its supplementary report to the legislature of last year, which, however, did not meet with favor from that honorable body."

Acceding to the repeated requests of the Commission, the

legislature finally amended the railroad laws in 1892—42 years after it had opened the door to unrestrained railroad competition. The effect of the amendment is thus described in the report of the Board of Railroad Commissioners for that year:

“The Railroad Law of 1892 imposes new duties and responsibilities upon the Board of Railroad Commissioners, the most notable of which reverses the policy of the State touching railroad extension, a policy which has prevailed since 1850. In that year, under the influence of public opinion, all encouragement that could be given, in the law, was extended to proposed investors. The policy then adopted has had a great influence upon the development of the state, but in the course of years abuses have crept in; railroads have been projected and built upon parallel and competing lines, which had no purpose but to compel older and established lines to buy the property of the rival or to sell their own. For a time these projects were looked upon with equanimity, as it was believed that such competition benefited the community through which the road passed by lowering rates, but it was discovered that such belief was fallacious. Unequal and unstable rates followed from the contests between the companies, which ended either in an agreement for higher rates or in the absorption of one company by the other, with the consequence of establishing higher rates permanently to support two constructions and equipments where one had sufficed. In the end communities were the sufferers; the day when the legislature could interfere and lower rates be made was postponed indefinitely. Other evils followed, such as niggardly economy in maintenance and in service, until public opinion demanded a restraint upon railroad building and extension. This restriction is expressed in section 59 of the Railroad Law of 1892, whereby the consent of the Board of Railroad Commissioners to the building of a road is a condition precedent to beginning an enterprise. The consent or withholding the consent on the part of the Board is made reviewable by the courts. In short, the State has de-

terminated to reverse its policy of the past by insisting that a public necessity shall be declared before further lines of railroad shall be built."

In 1895 the scope of the amendment was extended to take in street railways. In 1905 an act establishing the Commission of Gas and Electricity provided for a certificate of authority to be procured before a gas or electric company could exercise any power or transact any business in the state. All of these provisions have been substantially carried into the Public Service Commissions Law; the laws of other states contain similar provisions, and the history of progress of regulation in those states has been much the same as that here described for New York State.

§ 158. (1) Duplication of Plants to Be Avoided

This record of legislation, indicating "an extension of policy progressing uniformly in one direction, has great significance."¹ The necessity which compelled the adoption of the policy and shaped its development suggests the principles which control its application. "These laws were unquestionably enacted for the purpose of prohibiting some public evil, to prevent results which experience had demonstrated to be injurious to the public. It is therefore incumbent to know precisely what evils were sought to be prevented by these enactments, and what the Commission, if it fairly and justly exercises the powers conferred upon it, must guard against.

"It is not possible to mistake the situation. The history of the past fifty years is full of warnings and replete with experiences which the deliberate judgment of the lawmaking body of the State, reinforced by public sentiment, has sought to avert. The evil is the unnecessary duplication of public utilities."²

¹ Matter of Buffalo, Rochester & Eastern R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.), 53a (542). This opinion contains a very excellent discussion and most of the material for this resumé has been obtained from it.

² *Id.*, page 543.

The project of a new public service corporation affects the interests of three separate groups: first, that of the owners of the new project; second, that of the community proposed to be served; and third, the owners of a similar project already serving that community. It can safely be assumed that the first two groups will act in concert and usually against the third, but neither the unanimity in desire of the two nor the objection of the other can be made controlling as to the admission of the new corporation.

"The legislature has determined that the fact that parties or corporations are willing to undertake the proposed enterprise and put in their own money or the money of others is not sufficient alone to justify permission to engage in the work. For forty-two years the public and the legislature did deem such willingness sufficient and the law stood upon the statute books accordingly. For reasons entirely satisfactory, based upon a long experience, the rule was changed. Obviously, the Commission is disregarding both experience and the law if it permits such willingness to be the controlling factor in its determination. Formerly the law was that the judgment of the promoters was to determine the result. The legislature and the people have come to distrust that judgment and have substituted in place thereof the judgment of the Commission. The Commission must exercise its judgment if it is not to violate its duty.

"Popular desire in the locality or localities through which it is proposed to construct the road has not been made the determining test. It would have been easy enough to have made it so, had that been deemed wise or prudent. An experiment has been made in that direction, the memory of which yet lingers in many counties of the State. By chapter 907 of the laws of 1869 municipalities were authorized to issue their bonds for stock of a proposed railroad. A considerable amount of experience of a very costly nature was accumulated during the next five years, and on November 3, 1874, the people voted

nearly two to one to amend the Constitution so as to forever forbid further experiments of that nature. If localities are not to be permitted to expend their own money in new railroad enterprises, their interest in the investment of other people's money in such enterprises may be deserving of high respect but can scarcely be deemed conclusive or controlling."³

§ 159. (2) Basis of Right for Protection Against Competition

Under a policy of regulation it is quite evident that corporations subject thereto have at least the semblance of a right to occupy undisputed the territory which they have appropriated by an overt attempt to render service therein. In fact, it is more than a semblance of right; it must be considered as a legal right and enforceable by injunction, provided the corporation seeking to avail itself of that right has affirmatively established a claim and continues to keep it by readiness and ability to serve the community. Thus, the Public Service Commission (Second District) of New York denied a certificate of public convenience and necessity to the Buffalo, Rochester and Eastern R. R. Co.⁴ upon the principal ground that it would compete with an established road whose "existing railroad facilities between the terminals named and over the proposed road are adequate for existing business," and adequate for very large increases in future traffic, so that there was "no reason to suppose the existing railroad will not be able to increase the carrying capacity as rapidly as the rail and lake carriers west of Buffalo increase their ability to offer them traffic."

A company cannot challenge the right of another corporation to enter a certain territory unless it is actually in that territory. Of course, there may be a contest between two companies as to which shall be permitted to occupy the territory,

³ Matter of Buffalo, Rochester & Eastern R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 532 (547).

⁴ This company proposed to build a road from Buffalo to the seaboard at a total cost of \$100,000,000. Its application was twice heard by the Public Service Commission and twice denied. See 1 P. S. C. Rep. (2nd D., N. Y.) 532 and 2 P. S. C. Rep. (2nd D., N. Y.) 55.

but in such a contest the protection of invested capital is not involved. It may be, however, that one of the contestants occupies contiguous or nearby territory so that the contested territory may be said to be within the sphere of the probable extension of its service. Such a case was presented to the Public Service Commission, Second District, in the application of the Islip Electric Light Company⁵ to exercise a franchise in the villages of Islip and East Islip, New York. The application was opposed by the Suffolk Gas and Electric Light Company upon the grounds that "it is already in the occupancy of the territory sought to be served by the petitioner and that it is at the present time serving satisfactorily the people of Islip and East Islip with electric light and power."

The question to be decided was how far the contestant could be said to be occupying the disputed territory.

"The petitioner has failed to show that the respondent is not at the present time competent and able to give good and sufficient service to the territory in question. Apparently it can render such service if called upon and given an opportunity by the public of the villages so to do.

"The question, therefore, is reduced solely to one of occupancy of territory. . . . It must be found that at the commencement of this proceeding the respondent company was already occupying and serving the western fringe only of the territory under consideration here, whatever may have been its willingness to extend its service into other parts of it.

"Under these circumstances a new company, composed of residents of the village and financed by local capital, asks for permission to begin operation in what must be deemed new and virgin territory so far as electric service is concerned. Its incorporators proved on the hearing a decidedly hostile frame of mind on the part of the community of Islip and East Islip towards the respondent company, caused principally by the failure of that company in the past to give good gas service,

⁵ Islip Electric Light Co., 2 P. S. C. Rep. (2nd D., N. Y.) 415 (422-424).

and the people of those villages evinced an unwillingness to take electricity from respondent on any terms.

"Under such circumstances the Commission feels itself constrained to grant the application. There can be no question of the duplication of distributing plants, erection of two sets of poles and the stringing of unnecessary wires, because the respondent company has at the present time practically no plant in operation in the territory; nor would the respondent have been justified from an economic standpoint in constructing one until there had been sufficient call for electric current from the public to be served. Such a call, according to the testimony, the public has no intention of giving to respondent, although the territory may be said to be within the logical sphere of its activities. There is no question involved of vested interests which would be injured by undue competition. The petitioner is the first in the field and entitled to the preference. While the Commission may feel that as a business proposition it would be more economical for the people of Islip and East Islip to take their electric light and power, provided they can make reasonable terms therefor, from the Suffolk Gas and Electric Light Company, it does not consider that it is its function to do more in a case of this kind than to refer to such a course."

It is of interest to know that within a very short time this new corporation was merged into another corporation under the control of the Suffolk Company.

§ 160. (3) Loss of Right for Protection Against Competition

An operating corporation which is both able and willing to furnish the quantity of service demanded may have lost its right to claim protection against competition by continued indifference to the legitimate demands of the community as to quality of service or the conditions under which that service will be available.

"Established companies should understand that the security

to their investment depends upon giving all the service to which the public is reasonably entitled, and such service as the state of the art fairly requires. When this has been done and continues to be done, they may confidently rely upon immunity from unwarranted or piratical attacks.”⁶ But, “if an existing concern is serving the public in an unsatisfactory manner, it is entitled to little consideration when it seeks to exclude competition.”⁷

The defaults of an operating company upon which the right of another to enter its territory are to be predicated, must be of a serious and substantial nature.

“The policy of this Commission, in cases where one light-company seeks to enter a field already occupied by another, requires that the applicant shall show that the company already serving the community is not doing so adequately and efficiently and that its failures are such that they cannot well be corrected by the exercise of the regulative powers of the Commission. Good service may now be obtained at reasonable prices in less expensive ways than by unnecessary duplication of plants, and the public interest does not demand that capital invested in good faith in the public service should be destroyed or impaired without good reasons to be shown affirmatively.”⁸

§ 161. (4) Requisites for Authorization of New Enterprises

Communities will especially welcome a new corporation which promises to furnish service at a lower rate than that of the present company. Communities have always invited such projects, and have always paid dearly, but they will, nevertheless, continue to grow enthusiastic over the possibility of competition. Too often they need to be saved from themselves, with no thanks to the saviour.

⁶ *Citizens Electric Service Company*, 1 P. S. C. Rep. (2nd D., N. Y.) 336 (345).

⁷ Heading in *Katonah Lighting Company*, 1 P. S. C. Rep. (2nd D., N. Y.) 46, quoted with approval in *Citizens* case, cited above.

⁸ *Niagara Falls Lighting Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 116 (126).

"The mere offer by an applicant seeking to enter a territory already served by another company to reduce rates is insufficient, standing wholly alone, to justify an authorization to make such entrance without further inquiry as to the adequacy of the rate to afford continuous high class service, and as to the ability of the company already serving the territory to reduce its rates to meet those proposed. If the existing rate is unreasonable, the Commission has the power to reduce it. If the proposed rate is not adequate to maintain the service at the proper standard and yield some return upon the investment, it should not be considered. If the applicant can afford to give the lower rate and maintain the standard of service, and the company serving the public cannot do so, then the right of the public to the lower rate is paramount and other considerations must give way. The progress of the world is dependent upon this principle." *

The corporation seeking to enter a certain community cannot expect the grant of authority as a matter of course, if its application has not been opposed or if contestant has been proved unworthy of protection. It should produce affirmative proof that it is financially able to begin and continue successfully the enterprise which it proposes to engage in. The question is equally serious whether the company is seeking to enter a field already occupied or one in which it meets no competition. If it is permitted to enter a field already occupied when it is not financially equipped for the full measure of the undertaking it may mean not only the loss of such sums as investors may put into that enterprise, but also complete or substantial loss to the other company because of the ruinous competition to which it will be subjected. On the other hand, should such a corporation enter a field representing virgin territory, among the evils which may follow are the loss to investors, the discouragement to other investments of capital in

* Matter of Oswego River Power Transmission Co., 3 P. S. C. Rep. (2nd D., N. Y.) 268 (273-274).

a similar enterprise, and the extended economic effects produced by the failure of the enterprise—effects which are not limited to the boundaries of local communities and are not confined to brief periods of time. Among the reasons set forth by the Public Service Commission for its denial of authority to the Buffalo, Rochester and Eastern Railroad Company was the failure of the applicant to show sufficient financial ability, resources, and connections, to justify the belief that it could construct a road costing \$100,000,000. The proof which the Commission had desired of the corporation in this matter was as follows:

“The burden of proof in this case is upon the applicant to satisfy the Commission that the gentlemen engaged in this enterprise are engaged in it in good faith, that they are persons of experience and persons of responsibility and not mere adventurers. It also devolves upon the applicant to show that possessing all these qualifications, financial and personal, there is some reasonable probability or prospect that the corporation itself, being a corporation with an authorized capital stock of \$3,500,000, with of course only one-tenth of it subscribed at the present time, is capable of financing this operation of this proposed road. Now, unless the applicant satisfies the Commission of the latter fact, as well as the other, it will necessarily have to fail in this application.”¹⁰

§ 162. Regulation of Rates

The regulation of rates is considered to be the most important function of public service commissions; it is supposed to affect the greatest number of persons. The necessity for it arises directly from the monopolistic nature of these corporations. Protection of the patrons of a utility demands that the charge made against them for the service rendered shall be no greater than is warranted by an investment necessary to

¹⁰ Matter of Buffalo, Rochester & Eastern R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 532 (607-8).

furnish that class of service; that it shall be no less is the demand of the utility which asks protection from ruinous competition, or from the necessity of dividing with another the available business in its territory. How to arrive at that charge has been a problem, the attempted solution of which more than anything else has influenced the development of public regulation.

Rates and Capitalization. Is there a necessary relationship between rates and capitalization? Where both are subject to regulation is there any requirement of law or public policy that the one be controlling as to the other? A great deal of protest was raised against the statement in the report of the Railroad Securities Commission that: "If railroad securities were to be issued only after express authorization of each particular issue by the Interstate Commerce Commission or other governmental agency, it is difficult to see how the government can thereafter correct the moral if not the legal obligation to recognize these securities in the regulation of railroad rates." It has been urged that there exists neither moral nor legal obligation; that rates are not based upon the amount of stocks and bonds outstanding but upon the investment, and, if there is such a discrepancy between the actual investment and the capitalization that a fair rate based on the former will not support the value of the latter, the investor must suffer the loss. There needs to be a clear distinction between two situations: the one where stocks and bonds have been issued and their proceeds used under the authorization of the same commission which seeks to regulate the rates, and the other where the status of the corporation's investment and capitalization had become fixed before regulation was undertaken. In the latter situation there may be basis for the assertion that the amount of outstanding stocks and bonds should not be permitted to influence the determination of rates, but even here there may be considerations of public policy, pointed out hereinafter, which will require that the effect of proposed rates

upon the present capitalization be carefully considered. In the first situation, however, there is a degree of interdependence which may make the one controlling as to the other.

If the commission authorizes an issue of securities and passes upon the incidents of their sale and disposition of the proceeds, it must necessarily have made certain assumptions somewhat as follows: the cost of constructing plant and getting the project under way will be so much; to meet that cost so many shares of stock and so many bonds will be issued; in estimating the number of shares and bonds, it will necessarily have considered the probable price at which they would be sold, and since there is no power which can force investors to purchase them at any price, the commission must have put itself in the place of the supposed investor and concluded that at a certain price the purchase of these securities will be a good investment in view of the probable earnings—to wit, the estimated available business times the proposed rate. Now as to the rate, two things are possible: either it was based on the prevailing standard for similar service, or it was computed on the basis of the cost of service to the company plus a return upon the company's investment. In any event, some certain rate was a necessary consideration in the commission's assumptions. Suppose the commission is then called upon to fix the rate, there having been no changes in the estimates of available business and costs, could it order a rate different from that contemplated in connection with the computations regarding capitalization?

The Massachusetts Commission has made a clear-cut statement of an unqualified responsibility. In a street railway case ¹¹ it said:

"The statutes under which these stocks and bonds were issued . . . made it necessary for the Board of Railroad Commissioners to find that the issues were 'reasonably requisite' or 'reasonably necessary' for lawful corporate purposes,

¹¹ *In re Blue Hill Street Railway Co.*, P. U. R., 1915-E, 371 (381).

before it could give its approval. In like manner, the statutes under which the property and franchises of the Milton Street Railway Company were purchased made it impossible for the purchase to take effect until its terms had been approved by the Board. The approval of these issues by the Board, coupled with its approval of the terms of the Milton purchase, must therefore be regarded as conclusive evidence, so far as the Commonwealth and this Commission are concerned, that the stock and bonds so issued represented legitimate investment, not excessive for the purpose, and as strong presumptive evidence that the investment was 'prudently' made within the meaning of the rule ¹² laid down in the Middlesex and Boston rate case.

"It does not follow necessarily that the company is fairly entitled to earnings which will enable it to pay dividends upon its stocks, or, indeed, interest upon its bonds. The Commonwealth has not guaranteed these securities, nor undertaken to protect stockholders or creditors against the consequences of mismanagement. If the company has wastefully or imprudently expended corporate funds obtained from other sources, or has in any other way been improperly managed, and if such mismanagement is the cause of a failure to earn dividends or interest, the company is the author of its own misfortunes, and the public cannot justly be taxed through the payment of higher fares to relieve its embarrassment."

Having once recognized the reasonableness of the issue of a certain amount of stock and bonds as necessary for the purpose of a prudent and honest investment, the Commission proposes later to accept that amount as a basis for rate-computations. This is, obviously, the just thing to do. The Commission is not proposing, however, to accept the amount of stock and bonds as a basic fact in and of itself but rather as the

¹² "We rule that under Massachusetts law capital honestly and prudently invested must, under normal conditions, be taken as the controlling factor in fixing the basis for computing rates; that reproduction cost, either with or without depreciation, while it may be considered, is not, under our law, to be taken as the determining basis for reckoning rates."

representative of a fact, viz., the investment honestly and prudently made. It may depart from that amount at any time if the fact is found to be otherwise, but the Commission acknowledges that as long as the circumstances surrounding the investment remain as they were presented to it when the capitalization was authorized, it will be estopped from finding a different measure of the investment from the amount of stock and bonds which it had itself authorized.

The existing capitalization will always be a material consideration in a rate case, either because of principles of estoppel operating upon the commission as above suggested, or because of the possible effect upon corporate credit, future financing, etc., but it will be only a consideration, and will not exercise a direct and controlling influence on rates. The remoteness of the relationship between capitalization and rates has been already suggested in § 138.

§ 163. Regulation of Operations

The regulation of operations is the counterpart of the regulation of rates. Any change in operating conditions must be reflected in the cost of the service, and that cost must be absorbed in the rate. To increase the cost is tantamount to decreasing the rate so far as the effect upon the company's earnings, and through the net earnings upon the value of its investment, is involved; conversely, to decrease the cost is to increase the rate.

Public service commissions have the power to prescribe operating standards, schedules, and practices. They may order structural changes or repairs for the betterment or maintenance of service. In the exercise of these powers they will be asked to consider costs, and indirectly they will control expenses. It is of vital distinction, however, that the quality or kind of service will be thus regulated and not the expense to the company; the probable effect upon costs will be considered, but the actual effect is not regulated and will depend upon the

arrangements which the corporation may succeed in making to comply with the order.

There have been no attempts to regulate operating costs directly. The practically insurmountable difficulties which stand in the way are obvious. Manifestly, it would be either betrayal of the public interest on the one hand, or absolute foolishness on the other, to predetermine the amounts to be paid for wages and materials. If the prices so fixed are insufficient to induce others to sell labor or materials, the operations of the regulated corporation will fail and the public be deprived of necessary service. Then, again, if the price be greater than that at which the labor and commodities could have been procured, the public must pay a greater rate for service than it should. On the other hand, should the price be so fortunately fixed as to represent just the amount at which labor and commodities could be procured, it will be precisely the same price as the corporation would have paid wholly independent of regulation.

§ 164. Requirements of Public Policy—(1) Safeguarding Investments

The exercise of the regulative power of a commission over the capitalization of the corporations within its jurisdiction is subject to a number of considerations not specified in the law but imposed by general public policy. These are given in this and the following sections.

Protection of an existing utility against unwarranted competition is the protection of the investor who has committed his capital to that enterprise. The commitment of capital has vested in him property rights which have at all times received the substantial protection of the common, constitutional, and statutory laws, and of the courts. This protection has been exercised mainly against forces operating upon the corporation itself and upon the corporate enterprise from the outside, e.g., in the making of confiscatory rates.

The individual investor, however, has also sought and has received a great measure of protection against his associates in the enterprise. For instance, he has been protected against the unfair use of power by those holding the controlling interest, or against the unconscionable conduct of those administering the corporate affairs. This protection has been accorded him either through the principles of the common law or by statutes. Public service commission laws, so called, have not produced very much that is new along these lines except so far as the provisions for publicity may inure to the better protection of some investors, and also in the measure that the regulation of capitalization, of accounts, and of operations may indirectly strengthen the position of the invested capital. All these results undoubtedly have been accomplished by these laws.

So much for the man who has already invested his capital. It has been a very interesting question whether under the system of regulating public service corporations in the occupation of territory, the issue of stocks and bonds, etc., there has not been evolved a new public responsibility to be administered by the regulating commissions, to wit, that of protecting people from making unwise investments. Does an authorization to issue securities carry with it the guaranty of the state, and, if so, to what extent? Does it not at least carry the assurance that they have been scrutinized by prudent men and found to possess investment value commensurate with the price at which they are offered? Does it not also carry the assurance that in the administration of the law and the exercise of the authority and power of the state, adequate provision has been made for the proper use of their proceeds and a sufficient return thereupon?

That the state does not guarantee securities issued pursuant to the authority of its regulating commission is well understood, while some states have gone to the extent of expressly disclaiming the responsibilities of a guarantor; for instance,

"No provision of this act, and no deed or act done or performed under or in connection therewith, shall be held or construed to obligate the State of California to pay or guarantee in any manner whatsoever, any stock or stock certificate or bond, note or other evidence of indebtedness, authorized, issued, or executed under the provisions of this Act."

If the state cannot be legally held as the guarantor of securities so issued, is there anything in the laws themselves or in the nature of the functions performed by the commissions to carry assurance to the would-be investor? The commission having ordered a certain rate, the ratepayer is entitled to assume that the rate is a reasonable one and may rely upon the supposition that the commission has fully investigated the facts. Does the investor occupy any relation at all analogous to that of the ratepayer to the extent that he may rely upon the supposition that the commission has fully acquainted itself with all the facts connected with the issue of the securities which it has authorized, so that it may be assumed that the securities constitute a reasonable investment? Commissions have, as a rule, taken the stand, expressed over and over again, that they do not vouch for the investment value of the securities which they authorize. Yet there is no doubt that the public has placed a large measure of confidence in these authorizations, and the conclusion that it is entitled to do so is unescapable.

One needs only to review the record of the avowed purposes to be accomplished by the enactment of these laws, and to analyze the powers given to these commissions and the specific duties imposed upon them in order to ascertain the reason for the public confidence which was so readily reposed in the authorizations of the commissions. Since the laws almost uniformly prescribe the purposes for which, and the conditions under which, securities may be authorized, it follows that the authorization carries with it the public proclamation that the securities are for a proper and lawful purpose, issued with due

compliance to the letter and spirit of laws which were enacted to remedy abuses and to enforce correct principles of capitalization. Moreover, if the authorization itself determines the price of issue, it is reasonable to infer that, with full information and mature judgment, the securities were thought to be worth that price; if such an inference were to be denied, regulation would become a farce; it would mean that the commissions themselves lend their authority to the perpetration of fraud in seeking to bring about the sale of securities at prices not warranted by their investment value. Such broad powers of inquiry are given to the commissions, and they have access to such an amount of data unavailable to the public at large, that they become charged with a well-defined responsibility. The public assumes that this is duly carried out and acts accordingly. Quoting the Public Service Commission, Second District, New York:

"We think that to a reasonable extent the interests of the investing public should be considered by us in passing upon these applications. The Commission should satisfy itself that, in a general way, the venture will be likely to prove commercially feasible, but it should not undertake to reach and announce a definite conclusion that the new construction or improvement actually constitutes a safe or attractive basis for investment. Commercial enterprises depend for their success upon so many conditions which cannot be foreseen or reckoned with in advance that the duty of the Commission is discharged as to applications of this character when it has satisfied itself that the contemplated purpose is a fair business proposition."¹³

An intimation of what constitutes the "reasonable extent" to which the interests of the investing public are to be considered is contained in a later opinion where it was stated that a decision of the Commission holding that a public necessity for the construction of the proposed road existed would be "a

¹³ Matter of Hudson River Elec. Pwr. Corp., 1 P. S. C. Rep. (2nd D., N. Y.) 51 (67-68).

finding upon which the public would have a right to rely, and upon which it incontestably would rely, that the road would in all human probability afford an adequate return upon the money invested in its construction. The decision of the Commission would unquestionably be paraded before would-be investors to satisfy them that they could safely put out their money in this scheme with a just expectation of an adequate return thereon. The Commission cannot be expected to make a finding which would produce such a result, unless it were thoroughly satisfied of the correctness of such finding.”¹⁴

“Beyond any question, the determination of the question of the necessity of the proposed road must lie largely in the solution of the question whether the earnings from its operation would be sufficient to pay any adequate and proper return upon the money invested in its construction. The law requiring the granting of a certificate of public convenience and a necessity was enacted for the purpose of preventing the construction of bankrupt roads and for the prevention of the evils which would follow from such construction. If it is clearly apparent that a road will be bankrupt from the outset, the granting of a certificate of public convenience and a necessity would be a direct violation of the spirit and purpose of the statute which should not be tolerated.”¹⁵

In still another case, this Commission was not satisfied as to the adequacy of earnings to support the bond issue out of which it was proposed to build a certain extension. Upon its suggestion, therefore, the corporation agreed to reduce the bond issue and sell shares of stock instead. “With this limitation of bond issue,” said the Commission, “it is believed that the extension would have a sufficient prospect of success to justify the Commission in consenting to the construction.”¹⁶

The aspect of commission regulation which has been the

¹⁴ *Matter of Buffalo, Rochester & Eastern R. R. Co.*, 3 P. S. C. Rep. (2nd D., N. Y.) 55 (129).

¹⁵ *Id.*, pages 93-94.

¹⁶ *Matter of Catskill Traction Co.*, 3 P. S. C. Rep. (2nd D., N. Y.) 189, 205.

most emphasized by the courts has been that of protecting the investor; they have repeatedly given expression to the concept of guardianship. The New York Court of Appeals has said: "It was designed to make the Commissioners the guardians of the public by enabling them to prevent the issue of stock and bonds for other than the statutory purposes."¹⁷ The Maryland Court of Appeals says: "The legislatures of many states have . . . through the media of public service commissioners, seen fit to establish a quasi-guardianship over prospective investors."¹⁸

The following quotation from a dissenting opinion of a former member of the New York Second District Commission in the Buffalo, Rochester and Eastern case, contains a clear exposition of an opposite attitude as to the extent of the Commission's responsibility:

"Where a satisfactory showing has been made upon the question of public necessity and convenience, I hold that the plan of the railroad being in itself a reasonable one, if the public be in no wise deceived as to the character of the enterprise or the securities which it offers; and if, after due consideration of all objections raised in opposition or by the unprejudiced judgment of the Commission, the investors still think the enterprise a good one upon which to expend their capital; then, with such conditions imposed as would preserve all due rights of existing roads and insure the proper execution of the project, the certificate should be granted.

"I do not hold it to be a part of the function of this Commission to prevent people from making bad investments; to attempt that will open the door to all forms of extravagant paternalism. It is our business, as I take it, to prevent fraud and dishonesty, and to stop overcapitalization wherever possible in all future issues of public service corporation securities, as such overcapitalization also tends to result in fraud

¹⁷ People *ex rel.* Delaware & Hudson Co. v. Stevens, 197 N. Y. 1.

¹⁸ Laird v. B. & O. R. R. Co., 47 L. R. A. (N. S.) 1167.

upon the public. Our peculiar function is to make the relations of public service corporations toward the public on the one hand, and the state on the other, as clear and honest as we can make them.

“ When we take the application of a railroad company which proposes a perfectly feasible route—between two of the largest cities in the state, on the direct line of through traffic—a railroad which is demanded, apparently without a single dissenting voice, by the people of fourteen counties through which it proposes to run; and decline to allow capitalists to invest in it because in our opinion it will not pay, we are setting up our business judgments as against those who are most interested, because they are the ones who purpose to put their money into the road, and deciding for them that they must not be allowed to make a certain investment because in our judgment it would not turn out profitably. Such a decision, to my mind, savors of a paternalism which is bound to be exasperating in the present, and I fear is a rather dire augury for the future.”¹⁹

There is, of course, a wider application of the principle to the application of which exception was here taken. There is the general public good which must be considered, to the extent that preventable loss to investors should be avoided, not because the individual investors will suffer, but because the community at large will suffer. The prevention of that suffering is not a paternalistic act; it is a legitimate exercise of governmental function.

§ 165. (2) Conserving Integrity of Credit

The public is entitled to such regulation as will maintain the integrity of existing money markets, uphold credit, and encourage the investment of capital. This requirement of public policy is superior to the local interest of the patrons of any one utility, or that of the investors therein. The applica-

¹⁹ Appended to decision after first hearing and reported in 1 P. S. C. Rep. (2nd D., N. Y.) 628, 629.

tion of this principle is invoked most often in rate cases, but it has force in relation to capitalization problems as well.

It is said that corporations have no souls, and perhaps for that reason they do not feel their loneliness. They have few friends at best, and a public service corporation has usually the least number while having the greatest number of enemies. Every hearing before a commission is therefore frequently taken advantage of by many classes of persons to bring up charges of overcapitalization, excessive rates, inadequate service, incompetence, and indifference, and all manner of corporate wrong-doing. Unfortunately it is true that opposing the corporation is too often made synonymous with befriending the public, and, vice versa, defending the cause of the corporation is made tantamount to betrayal of the public. This attitude has encouraged many to seek popularity and personal power by always demanding additional service and lower rates from the corporation, and concurrently increasing taxes, demanding franchise fees, and opposing additional capitalization. If all these efforts could succeed, the public service enterprise would come to a Samsonian end; it would eventually succumb before its harassers, at the same time destroying their welfare also. The results would be loss of capital, and loss to the patrons of the service, but worst of all would be the loss of faith and credit which would penalize worthy projects because of the unwillingness of investors to place capital at the hazard of attack if there is the prospect of prejudice being the victor.

Public service commissions will often be asked to accede to the wishes of the interested public, or to act according to the behests of those who measure public interest by the scope of their own narrow outlook. It will be easiest and most popular for a commission to follow this course, but it is to the credit of most commissions that they have clearly understood the nature of their task and held true to the performance of their trust, thus becoming instruments for the protection of the public faith and credit. These commissions are not the agents of

the patrons of the public service corporations any more than they are of the investors in those corporations; they are trustees appointed by the people at large, and in their custody is placed the public faith and credit to be administered without prejudice or self-interest.

§ 166. (3) Promoting the Public Interest

In a number of ways the commission will find it necessary to consider the interest not of one community but of the state and people in general while passing upon applications which include proposals to issue stocks and bonds. For instance, although under the statutes one corporation may not purchase the plant of another or acquire the stock of another without the consent of the commission, there are few express instructions of the law that the commission is directed to follow, and these are generally limited to "anti-trust" regulations defining the consolidations, mergers, and other combinations which are permissible. In the main, the considerations which will be controlling as to the decision of the commission will be those which it has itself set forward as arising out of public policy. So also in considering applications to exercise franchise rights in a given community; the community itself may have granted the franchises and be anxious for service to be inaugurated, but the commission must stop to inquire as to the character of service proposed, and to determine whether it is such as to promote the public interest.

A very interesting problem was presented to the New York Public Service Commission in an application for authority to construct an electric generating plant upon the Sacandaga River at a time when there was much public discussion as to committing the state to a policy of water power development.²⁰ Tentative surveys were also under way with a view to possible construction of a large dam by the state upon that same river at a point very near to that intended to be occupied by the

²⁰ *Matter of Hudson River Electric Power Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 51 (72-74).

electrical corporation. It was for the Commission to decide whether consent should be given to the private development of a water power project which the state might later desire to acquire. There is no indication in the opinion as to what decision would have been made if the state project had been a fixed one; as it was, the application was granted because the Commission had not been advised that the proposed plan would "interfere with the public health, maintenance of the forest preserve, or any defined project of the state." One of the Commissioners dealt with these particular aspects of the application very fully in a concurring opinion. He said:

"Obviously this Commission is not called upon to decide as to whether such policy (the proposed policy of state water power development) is or is not a wise one; nor whether being wise or unwise, it is likely or not to be carried out by the state either now or in the future; yet it is the duty of this Commission, if it be possible, to so act that if the state should decide to follow along the lines indicated by the Governor's message and the Fuller Bill, no action of this Commission shall put the state in a less advantageous position than it would have been in if this Commission had not acted.

"In other words, this Commission should not by its act enable a private owner to gain vested rights in a water power which will force the state later on to pay more for the control of that water power than a sum represented by the amount actually expended by such private owner in acquiring and improving the property. The private owner should not be permitted to claim over and above the actual cost of his investment, the unearned value which the action of the state itself has created, and thus make the state pay for the very thing it has given. . . .

"When the choice comes squarely between granting or rejecting the application . . . there is this further consideration: The conditions seem to be such that if the state should ever determine to develop the water power of the Sacandaga

valley it could do so with such manifest advantage to the Hudson River Electric Power Company that there is every reason to believe that company would have every incentive to further rather than hinder such development. The self-interest of the private owners may thus yield to the state what the state might better have the legal right to exact."

CHAPTER XVI

FIXED AND FLOATING CAPITAL AND THE ACCOUNTING THEREFOR

§ 167. Fixed and Floating Capital

The capital of a public service corporation, viz., "all property devoted to the rendering of the services or the production of the commodities which are within the purposes of the corporation,"¹ is divided into two main classes: fixed and circulating (or floating). Circulating capital is entirely consumed in the rendition of a particular item of service; fixed capital remains in service for a comparatively long period and is consumed over a series of operations. "Coal on hand is a current or floating asset. It can be used but once and is destroyed in the use. . . . The machine which utilizes the energy furnished by the combustion of the coal is a factor in the productive process but is not classed with floating assets or capital. It can be used again and again during a term of years. . . . The consumption of the coal is visible and apparent; the consumption of the machine is not visible, extends over a term of years and through a long series of production."² It will readily be seen that the distinction between the two kinds of capital is mainly one of degree rather than of kind or substance.

It is sometimes difficult to distinguish between fixed and floating capital without some established rule, and an arbitrary line of demarcation is usually drawn at one year, thus classifying as fixed all capital having expectation of life in service

¹ Definition from Uniform Systems of Accounts, New York Public Service Commissions.

² Matter of Binghamton Light, Heat and Power Co., 1 P. S. C. Rep. (2nd D., N. Y.) 171 (184).

of more than one year. In the accounts of a corporation the disposition of cost of fixed capital is very different from that of floating capital. The usual period for which accounts are assembled and studied is the year, hence the year is also the standard to determine the character of capital. That which is going to affect the accounts for a period longer than that constituting the fiscal year for which the accounts are assembled is fixed capital; that which will affect the accounts for that period only is floating capital.

Expenditures upon both classes of capital are chargeable in the first instance to accounts the balances of which will represent assets on the balance sheet. But one will represent a relatively permanent fact and be classed as an investment, while the other will appear only temporarily in a Materials and Supplies account pending the use in the productive process. There it will be wholly consumed and its cost will cease to be an asset, and become an expense of operation to appear in the Income account and not on the balance sheet.

Obviously, capital which will continue as an asset after the closing of the Income account should not have its entire cost charged to income, for then it will be recorded as an expense of operation to be deducted from revenue, with the result on the one hand that the gain from operation will appear at less or the loss greater than it should, while on the other hand the balance sheet will fail to show an asset on hand and will thus create a "secret reserve," so called. And yet, this very practice has been and continues to be considered a commendable one as denoting a conservative policy in "building up the capital out of income." Often the chief excuse for the practice is the pre-existence of another error, to wit, the present inclusion in the balance sheet asset accounts of amounts which never did represent, or have since ceased to represent, actual assets. The inflation thus introduced into balance sheet accounts is then sought to be made good by subsequent acquisition of assets through income. The aim is all right, but the

difficulty is that neither the balance sheet accounts nor the income accounts will represent the facts they purport to record, while no one can use the resulting statements in any way to ascertain how much the inflation was, how much has been made good, and how much remains to be made good. It may be an eminently worthy act to apply earnings to strengthening corporate resources rather than to divide them as dividends, but there are more appropriate methods of recording the incidents of such an act.⁸

§ 168. Basis of Fixed Capital Accounts

There naturally arises at this point the question as to the proper basis of showing fixed capital upon the balance sheet. It is an asset, and assets are supposed to represent available values. What is the available value of fixed capital, and how can it be ascertained and recorded?

The fixed capital account of an operating public utility corporation (distinguished from a holding company) is the most important record which it can have. Upon that basic record will depend the value of all future records of operations. Most abuses of capitalization have been made possible by manipulation of the fixed capital account, hence the imperative demand for accuracy and detailed accounting in this respect.

Three methods of showing the fixed capital upon the balance sheet have been used. The first is based on the original cost of the fixed capital in service; the second, on present value as measured by the probable cost to reproduce or duplicate; the third, on present value measured by the earning power of the capital in that service wherein it is placed. So far as the initial entries for a new corporation are concerned, the practice would not vary much under the first two methods, for the cost to duplicate must necessarily be the same as the cost to acquire. Since earning power has not been developed, it would

⁸ See Chapter VII, § 69.

seem as though the practice under the third method would produce like results as for the other two. A singular confusion of the theory that the capitalization should show earning value, however, together with the belief that there should be some uniformity in the relation of capital to the par value of stocks and bonds issued against it, has led some accountants to the practice of entering original fixed capital or subsequent additions at an amount equaling the par value of the stocks and bonds issued for the purpose and altogether irrespective of cost or value. The more obvious purpose is, of course, that of escaping an apparent deficit at the commencement of operations.

Beyond the initial entries the results of the three methods will differ widely. Following the second method, the original entries would be changed to show the valuation of the assets at the later date, the account being written up or down by the difference between the present and the last valuation. As a rule, however, it is only when the facts are so obvious as to be inescapable of notice that a corporation will write down its capital accounts—unless it has a large apparent surplus which it is policy to diminish otherwise than by the declaration of dividends. More often the valuation of assets is sought to be made by friendly interests, and upon their report the capital is written up to create apparent surplus for distribution as dividends. Upon the third method the accounts will be written up or down (the latter being very seldom done) in accordance with a valuation of the property reflecting the figures of earnings developed in operations.

Neither of the two "value" theories (i.e., reproduction cost or capitalized earnings) will be found upon examination to produce the results desired of them. Cost of reproduction will represent available value only when the article is one freely reproduced, bought and sold. Comparison of the article to be valued with the price of like articles on the market will give its cost of reproduction (allowing for present conditions), which will be its available (maximum) value. The fixed capi-

tal of public utilities lacks these characteristics of reproducible articles; it is impossible to find two plants with characteristics absolutely identical—equal in quantity, kind, and condition of capital, serving territories which are alike in point of demand for service and willingness to pay a similar rate. Hence, it is impossible to get the value of one plant by comparison with another, so that the value must be based upon a series of facts relating to the one plant under consideration. According to the nature of the fact examined, the “value” thus derived will be either of the following: (1) It may be an abstract and constructive “value” represented by the aggregate cost of the many units of capital which have gone into the plant—which will not be value at all since the units which went into the plant have by the very fact of use lost the value which they theretofore possessed as so much material in steel rails, piping, wire, etc., and collectively have assumed a new value which is the very figure sought for. (2) Or it will be the worth to the owners of the plant in service as a productive machine; but that last is the value of the undertaking as a whole, not at all subject to allocation among classes of assets, even though it is bound to relate most of all to the fixed capital, which is the largest asset item. This second result, if taken upon the books, will represent substantially the capitalization of earnings. It follows that the fixed capital cannot be shown upon the balance sheet under either of the “value” methods.

The Test of Value. The measure of real value is what a person will give for the article, the plant, or whatever else it may be. It is not what the present owner paid for it; neither is it what he would like to get for it. On the other hand, it is not what a casual buyer will offer, but rather it is the amount which a buyer with serious purpose and complete information as to the condition of the property, the volume, kind, and cost of the business, the record of past development, and reasonable prospects, will offer. How can the present owner anticipate the amount of such an offer? He may be able to make a very

close estimate, but in his calculations he will take into consideration certain ratios, e.g., of earnings to amount invested, of capital representing investment of earnings to original capital, of cost of service to revenues, etc. All these facts are book records which would be modified if he placed on the books the result of his calculation as to value, and which in turn would necessitate another calculation, and so on.

The Cost Basis. The cost of the plant does not represent available value. It is, however, a fact related in kind and origin (not necessarily comparable in amount, however) to other facts shown upon the balance sheet, to wit, the capital stock and bonds which were issued for its acquisition. If the corporation had to account to its bondholders right then and there, it might be able to pay a fraction only of the par of bonds, and nothing, or little, on the par of stock. Nevertheless, its accounting does not and could not take cognizance of such contingencies; it can and does record a historical fact—the obligation of a promise to pay, i.e., the par of the bonds, and the amount received from stockholders. It would be illogical and untruthful—for a half truth is equal to an untruth—to show a part of a complete transaction on one basis and another part on another basis. Hence, in showing the stock and bonds in the manner indicated, the corporation must show on a like basis the capital acquired, except as parts of it have been lost (e.g., abandoned without replacement in kind or value of assets) or superseded (e.g., replaced in kind or substituted by another asset; for example, consumed in operation and its value replaced by cash or some other current asset). That like basis is cost—a historical fact of present interest, reflecting the manner in which the corporation has discharged its responsibility to invest in the business the proceeds of its stock and bond issues. Cost in terms of cash is the basis prescribed by public service commissions generally and by the Interstate Commerce Commission in their accounting orders. The text of the general instructions for fixed capital accounting issued

by the New York Public Service Commissions is as follows:

"All charges made to capital shall be the actual money cost of the things in respect of which they are made. When the consideration actually given for the thing in respect of which a charge to a capital account is made is anything other than money, the actual consideration shall be described in the entry with sufficient fullness and particularity to identify it, and the amount charged shall be the actual money value of such consideration at the time of the transaction.

"Cost of labor includes not only wages, salaries, and fees paid employes, but also such personal expenses of employes as are borne by the corporation. Cost of materials and supplies consumed in construction is the cost at the place where they enter into construction, including the cost of transportation and inspection when specifically assignable. If such materials and supplies are passed through storehouses, their cost entered in the account may include a suitable proportion of store expenses."

Undoubtedly the practice of recording cost is the best under the prevailing conditions; it preserves the most significant figures and those which all parties desire to keep. The cost of duplication, or valuation upon the basis of earning capacity, can be determined at any time by independent examination, but the original cost can never be determined if the records fail to show it. The chief objection to this method comes from stockholders who complain that this does not permit them to enjoy the benefits of appreciation of values. It is not necessary at this point to discuss the problem of unearned increments of value, but it may be stated as a fact that there is nothing in the method which will withhold from the stockholders the benefit of any real and available values, i.e., values which they could convert into cash and take out of the corporate enterprise.

It is most unfortunate that any measure of discredit should have been cast upon the cost basis by its supposed ad-

vocates. In its annual report for 1908 the Interstate Commerce Commission used the following argument in its plea for a physical valuation of railroads:

"A third argument in support of the plant as an authoritative valuation of railway property is found in the present unsatisfactory condition of railway balance sheets. The balance sheet is, perhaps, the most important of the statements that may be drawn from the accounts of corporations, for, if correctly drawn, it contains not only a classified statement of corporate assets and corporate liabilities, but it provides in the balance, that is to say, the 'profit and loss,' a quick and trustworthy measure of the success that has attended the operation and management of the property. Every balance sheet begins with 'Cost of property,' against which is set a figure which purports to stand for the investment. This is no place to enter upon an extended criticism of the practice of American railways in the matter of their property accounts, nor is such a criticism necessary for the purpose in hand. It is sufficient to refer to the well-known fact that no court, or commission, or accountant, or financial writer, would for a moment consider that the present balance sheet statement purporting to give the 'cost of property' suggests, even in a limited degree, a reliable measure either of money invested or of present value. Thus, at the first touch of critical analysis, the balance sheets published by American railways are found to be inadequate. They are incapable of rendering the service which may rightly be demanded of them. One cure seems possible for such a situation, and one only, and that is for the Government to make an authoritative valuation of railway property, and to provide that the amounts so determined should be entered upon the books of the carriers as the accepted measure of capital assets. Under no other condition can the Commission complete in a satisfactory manner the formulation of a standard system of accounts."⁴

⁴ Pages 82-85.

It would seem that, in the opinion of this Commission, recording fixed capital at cost is only a temporary expedient, and that recording values is practicable, provided the Commission is the one to say what that value shall be. It seems to overlook altogether the fact that, even if it had all of the authority of directors, stockholders, courts, and legislators, it could not control the changes which would begin to affect that value even before the pronouncement of the value as of a particular instant could be made.

§ 169. Necessary Detail for Fixed Capital Accounts

The bookkeeping record should be in as great detail as necessary to identify as far as practicable the several units of structures or equipment, so that the cost of the plant used in rendering service to separate communities, or for different kinds of service, may be easily ascertained. Very often where proper detail has been neglected in the original entries, thousands of dollars have been spent later to ascertain facts which could easily have been indicated in the first instance. The report of the New York Public Service Commission, Second District, for the year ended December 31, 1916, discusses this aspect of fixed capital accounting as follows:

"Allocation of Fixed Capital: In last year's report it was shown that to the effective date of the accounting orders of the Commission, practically all of the public service corporations had but one principal plant account to represent the investment in the business. With capital accounts of this character the corporations do not know the original cost of their investment devoted to the different classes of their service, or to the different localities served; nor are they in a position to determine the costs or the profits of their different operations or operating divisions. Another very important disadvantage is that the lack of knowledge of the costs of the various elements of the property makes it practically impossible for the corporations to estimate with any degree of accuracy the amount of the annual

depreciation or amortization which is required, for unless the investment which should be amortized during the life of a unit of property is known, it is almost impossible to determine the annual reservations from income which should be made with respect to such property. Furthermore, the corporations are required by the accounting orders of the Commission to credit their fixed capital accounts in which the former plant accounts are now incorporated with the cost of property retired. This means that unless the cost of a unit is estimated (which practice is never satisfactory), an analysis will have to be made of the charges to fixed capital during the period in which it is thought the property which is to be retired was purchased. Very often the property to be retired was bettered after having been in service several years, and it therefore becomes necessary to inquire further into the fixed capital account in order to determine the value at which the property is carried in that account. Last year this division reported that in order to correct this unsatisfactory condition in their accounts, many corporations were analyzing their entire plant accounts, in order to learn their investment in the different classes of property and also in the different localities. These analyses automatically eliminate from the investment account amounts which represent property which has gone out of service, and indicate other amounts which are not properly representative of the investment in the property devoted to the activities of the corporation. Usually the results of the inquiry into the plant account are brought into agreement with a physical inventory of the property in service. In effect, these inquiries amount to a retroactive application of the Commission's accounting orders to the earlier corporate life of the properties involved. . . . Practically all of these analyses have their inception with applications by these corporations to the Commission for authority to issue capital stock or mortgage bonds, to merge, consolidate, or sell such properties. As the corporations which have not as yet properly assigned the

charges to their plant accounts over the property which they represent, come to the Commission for authority to issue capital securities, this very important inquiry into their capital accounts will receive attention."

§ 170. Additions and Betterments Accounts

Necessarily the basis adopted for recording original capital must also serve as the basis for recording additions and betterments of capital. Additions are defined in the Uniform Systems of Accounts of New York to include "additional structures, facilities, or equipment not taking the place of anything previously existing. Betterments include the enlargement or improvement of existing structures, facilities and equipment." Definitions are important in accounting.

§ 171. Accounting for Fixed Capital Withdrawn

It seems too elementary to warrant emphasis that fixed capital accounts should show only costs for the capital actually in service, and that, if any part of the capital is abandoned or retired from service, its cost also should be taken out of the fixed capital accounts. That this has not always been done is due to the fact that incorrect accounting has often found corporations unprepared to record the retirement without greatly disturbing their accounts. If they have not anticipated the retirement by making due provision therefor, in crediting the fixed capital accounts they would have to debit the profit and loss accounts, thereby reducing the apparent surplus or increasing the deficit. In its annual report for 1912, the New York Public Service Commission for the Second District said:

"At this time, however, some of our railroads and other corporations too, are undoubtedly reporting as in service and of value, equipment and other property which would be sent to the scrap heap or sold for junk or discarded as worthless but for the reverence for surplus and the desire to have the business appear more prosperous than it is in fact."

Moreover, these corporations, when they faced the necessity of retiring certain old capital and replacing it with new, were remanded to the expedient of paying for the new out of the proceeds of stocks or bonds; but investors are not anxious to advance funds for the purchase of capital which should have been anticipated by charges against the operating expenses of past periods. To carry through the expedient, therefore, it was necessary to represent the new capital as an addition and not a replacement, which could be done only by neglecting record of the retirement.

Through its entire experience, the New York Commission for the Second District has uncovered again and again the continued use of this practice, describing one instance as that of an "apparently prosperous company which in the past seven years has been able to practically rebuild its plant at a cost of \$175,000, using therefor the sum of \$61,000 out of surplus earnings, and which at the end of the period was able to pay its fixed charges and have a surplus sufficient to declare an annual dividend of 4 per cent upon its capital stock. In its balance sheet this plant and equipment was placed at the sum of \$651,864, which can scarcely be construed other than that the tangible assets of the corporation are carried upon its books at that value."⁵ And yet, excluding intangibles and some items which were found to have been improperly charged to capital, out of \$342,204 supposed to represent its tangible capital at least \$55,000 represented capital which had been wholly abandoned, scrapped, or destroyed.

"The plainest principles of good accounting require that the portions of the plant thus taken out of existence should have been credited to capital at the amounts they were charged in the books at the opening of the company's books. Nothing of the kind has been done; while on the other hand the new work, which was nothing more or less than replacement, has been charged in full to plant and equipment, so that Plant and

⁵ Matter of Niagara Light, Heat and Power Co., 2 P. S. C. Rep. (2nd D., N. Y.) 90.

Equipment now stands charged with the amount of the old work which has been destroyed and taken out and the cost of the new work which has replaced the same. Any just and correct statement of the affairs of the company requires that \$55,000 should be credited to capital; and if this is done, Plant and Equipment, as representing the tangible assets, will be reduced from \$344,204 to \$288,204."

A similar condition which developed upon the investigation of another application was described as follows:

"Examination of the company's affairs disclosed that it commenced business March, 1902, with a physical plant which was charged to Fixed Capital in an amount not precisely ascertained but which it is just to assume was approximately \$500,000. Since that date the company has practically rebuilt its physical properties, the valuation placed by the Commission's engineer upon the part remaining being \$51,000. The company has credited nothing to Fixed Capital on account of the property thus displaced and destroyed except the sum of \$15,617, the amount realized by it for junk from such displaced plant. The remainder of the original charge to Fixed Capital on account of such displaced plant it still carried upon its books as an asset. . . . The value of the replacements has also been charged to Fixed Capital, so that both the destroyed plant and the replacement thereof appear in the company's balance sheet as assets."

The balance sheet on December 31, 1908, showed the amount of fixed capital at \$1,302,726, the portion thereof representing the destroyed plant being "substantially 40 per cent of the whole. . . . Such a statement of assets is too grossly misleading to those who may be asked to buy its stock or bonds to be approved. Accounts and balance sheets should state facts and are assumed to do so. If this company should plainly write in its balance sheet the exact facts—'Old plant now wholly non-existent, \$500,000'—it would be full notice to every one that its affairs were in precisely the condition which

would be shown were it to strike out the item wholly from Fixed Capital and create a balance by writing 'Deficit, \$500,000.' " " *

To enforce the principles of correct accounting which the Commission had in mind in these cases, the accounting rules formulated by it contain the following requirement: "When anything is withdrawn or retired from service, the amount at which such thing stood charged in the capital account shall be credited to the capital account in which it stood charged at the time of withdrawal, and the entry of such credit shall cite by name and page of book or other record the original entry of cost of the thing withdrawn. . . . If such amount is not known, it shall be estimated, the facts upon which the estimate is based shall be shown, and the amount thus estimated to be the original charge in respect of such thing withdrawn shall be credited."

§ 172. Maintenance and Depreciation of Fixed Capital

Changes in fixed capital which must be properly reflected in the accounts are constantly occurring. The designation "fixed capital" may convey the idea of permanency, but only relative permanency is contemplated in the use of the term. "All machinery is on an irresistible march to the junk heap. The machinery is gradually worn-out or consumed in the process of production precisely as the coal is consumed. The consumption of the coal is visible and apparent. The consumption of the machine is not visible, extends over a term of years and through a long series of production. The cost of the coal enters into the cost of, we may say, one article of the product of the machine. The cost of the machine enters into the cost of thousands of the articles it produces. The operations of production ultimately destroy both the floating capital and the fixed capital (with some few exceptions, such as land)

* Matter of Binghamton Light, Heat and Power Co., a P. S. C. Rep. (and D., N. Y.) 172. First part of quotation is from headnote.

concerned in such operations. In one the destruction is immediate; in the other it is slow and spread over a series of years."⁷

Maintenance expenses are those which record the current consumption of fixed capital. They are the accounts which carry to the cost of the product the value of the fixed capital consumed in the process of manufacture.

If the use of the fixed capital is to be indefinitely continued, it must be continually kept at its utmost operating efficiency which, presumably, is the measure of its performance when installed new; thus there must be constant observation of the destruction caused by operations and the destroyed parts must be replaced. No man will buy a suit of clothes and expect to wear it any length of time without giving some attention to the maintenance of its condition and appearance. But, even then, no matter how much care he exercises in the use of these clothes, keeping them cleaned, pressed, and repaired, he will not be able to wear them throughout his entire life—sooner or later the clothes will wear out; or, if made of such good material as to last a long time, the man will outgrow his clothes or let them outgrow him, so that in the end he will have to abandon them. Fixed capital bears the same relation to the business as clothes do to the man in this respect. It will get old; there will be wear and tear which will never be made good through repairs; if happily its life be capable of great prolongation, the business will outgrow the capital. Through the progress of the art or through expansion of the business the capital may become obsolete and utterly inadequate, so that, like the clothes, it will need to be abandoned, to be replaced with other capital. It does not become worn-out all of a sudden, except as it is destroyed by accident, such as fire, flood, or other casualty; nor does it become obsolete or inadequate in the twinkling of an eye. When abandonment becomes neces-

⁷ Refer to quotation in § 167 of this chapter from opinion in *Matter of Binghamton Light, Heat and Power Co.*

sary it is the result of a process just as sure as the more apparent one of reparable wear and tear, and the expenses entailed in this process are just as much costs of production as any other maintenance expenses. This process is described as depreciation. Technically, depreciation should include the entire process of the destruction or consumption of fixed capital in the productive process whether the wear and tear is reparable or not; however, it is understood in most cases to indicate the irreparable wear and tear and the loss in value through obsolescence and inadequacy.

§ 173. (1) Relative Importance of Maintenance Expense Accounts

Maintenance expenses constitute a very important group in the operating expenses of public utilities. Proper practice in this respect is therefore very essential to accuracy in the statement of earnings and surplus. For the sake of classification we may think of maintenance expenses as representing three conditions. First, imperative maintenance or repairs which must be made forthwith if the machine or other apparatus is to be kept in use; the breaking of a bolt or of a wheel will incapacitate a locomotive and the broken parts must be replaced immediately in order not to lose the entire investment in the apparatus. Second, optional maintenance, or restoration of deterioration which should be made good but the need for which is not compelling, e.g., reballasting roadbed, repainting structures, etc. Third, depreciation through irreparable wear and tear, obsolescence, and inadequacy.

These are classifications in degree only and the lines of division are indefinite; for instance, optional maintenance, if long neglected, will soon become imperative. The classification is important, however, in its bearing upon the manipulation of maintenance accounts. In the case of imperative maintenance the company has little choice in making the expenditure; on the other hand, the expediency of repairs which come within

the class of optional maintenance has very often been determined not by the physical facts, but by the condition of the expense accounts and the desirability of keeping them within such limits as will permit satisfactory earnings to be shown for that period, in the hope that the operations of the following period will be sufficiently better not only to stand their own maintenance burden but also those brought over from preceding periods. Within certain limits, of course, some kinds of optional maintenance are properly subject to considerations of expediency; the repainting of a structure, for instance, may sometimes well depend on circumstances as to whether it should be done this year or next. The unfortunate results of subordinating maintenance to other considerations are too apparent to require description; the decreased efficiency caused by neglecting repairs increases total expenses by more than the amount which was required for the repairs when the wear first became noticeable, to say nothing of the deterioration in service which is bound to follow. Should the expectation of sufficiently improved operations in succeeding periods prove to be ill-founded, the results will be disastrous.

§ 174. (2) Depreciation Accounts

The complete neglect of accounting for maintenance expenses of the third class, to wit, depreciation through irreparable wear and tear, obsolescence, and inadequacy, is almost as often the result of ignorance as of intent. But where depreciation charges are regularly included in the accounts, it is of the greatest importance that the method of ascertaining the amounts be a correct one; slight changes in the method may produce great fluctuations in the maintenance accounts. There are few subjects in accounting which have caused as much discussion as that of depreciation. The literature on this subject is increasing annually, but the progress toward unanimity as to method of procedure is very slow. In the first place there is no unanimity of opinion that depreciation should be taken

into the accounts at all, beyond that which is subject to current maintenance, so that if the property is maintained to standard the consumption of capital is sufficiently absorbed by the costs of production. Then, even where the necessity of recording depreciation is admitted, there is great diversity of opinion as to the methods used in ascertaining its amount, the factors to be considered, etc.

To support the claim that it is unnecessary to take up formal depreciation charges to record the consumption of capital, beyond that recognized in the current maintenance expenses, it is contended that there can be no measure of the loss, and that any attempt to determine the loss will be arbitrary and consist of mere estimates. The question of estimates forming the basis of depreciation charges has proved the stumbling block to many who contend that the operating expense accounts should reflect facts and that they have no business with guesswork. But depreciation is an unquestioned fact; in the carbonization of coal for gas-making purposes, for instance, the fractional consumption of the apparatus utilized is as indubitable a fact as is the consumption of the coal. Even those who argue against formal depreciation charges cannot deny the fact of depreciation. The matter to be estimated is not the depreciation itself, whether any exists or not—a fact readily ascertainable—but the amount of the money loss involved if there is depreciation. The fact of depreciation once admitted, the logical conclusion is that an effort should be made to determine its amount, and if exact determination is not practicable and only a possible approximation can be had, it is far better to accept the approximation and make charges accordingly than it is to ignore the fact altogether. It is further urged, however, that a correct statement of net revenue is in danger quite as much by an overcharge as by an undercharge to operating expenses, and that, since a charge for depreciation must rest so largely upon estimates, it is possible that the estimate may call for a charge of an amount greater than is necessary,

so that the net revenue may be understated. The objection has some merit, but its validity and force extend only to the need of great care in making the estimate and not to the fact of depreciation itself. It will not be long before any gross errors in the approximations will become manifest and can be corrected, so that little by little the approximations will more nearly correspond to the facts as they are.

It is not necessary to review further the arguments for or against formal depreciation accounts; it is sufficient to note that they are required almost uniformly by all public service commissions in their respective states as well as by the Interstate Commerce Commission.

§ 175. (3) Method of Recording Depreciation

The consumption of fixed capital is a slow process which goes on constantly; when the need for repairs becomes apparent, except that caused by accident, it is only an indication that a certain stage has been reached in this slow process. It has been thought desirable by some accountants to devise a system which will reflect in the operating expenses the consumption of capital even before the repairs are made, thus equalizing expenses and profits of various periods and obviating the possibility of manipulation through postponement of optional maintenance. If the entire consumption is to be reflected, the depreciation also must be included. This theory has been given effect in the accounting orders of the New York Public Service Commission for the Second District; for instance, the instructions of the accounting order for telephone corporations are as follows:

“Every telephone corporation shall include in its expenses depreciation charges for the purpose of creating proper and adequate reserves to cover expenses of depreciation currently accruing in its fixed capital. By ‘expense of depreciation’ is meant the loss suffered through the current lessening in value of tangible property from wear and tear, decay, obsolescence,

or inadequacy resulting from use, age, physical change, or supersession by reason of new inventions and discoveries, changes in popular demand, or public improvements; also losses suffered through destruction of property by extraordinary casualties and decreases in the value of intangible property through the lapse of time.

"The amount charged as expense of depreciation shall be based upon rules determined by the accounting corporation. . . . The rates of depreciation should be fixed so as to distribute, as nearly as may be possible, evenly throughout the life of the depreciating property the burden of repairs and the cost of capital consumed in operations during a given month or year and should be based upon the average life of the units comprised in any class of property."

The accounting method to carry out this theory is to set up a depreciation account in operating expenses, with a corresponding depreciation reserve which will appear on the balance sheet as a reservation of earnings. The amount estimated to cover the consumption of capital during the period will then be debited to the depreciation account and credited to the reserve; when repairs are made the cost of repairs will be credited to the depreciation account and debited to the reserve, leaving in both accounts a balance which will represent the consumed capital not made good. The balance of the depreciation account will be closed out into operating expenses, while the balance of the reserve will be a deduction from the fixed capital account. The form of a balance sheet will sometimes show the actual deduction of the balance of the reserve from the fixed capital account on the asset side of the balance sheet, while other forms will not disturb the asset side at all but will include the depreciation reserve on the liability side. The use of the reserve account does away with any credits direct to the fixed capital accounts for accrued depreciation. The method of crediting depreciation direct to the fixed capital accounts is objectionable, for it tends to destroy the integrity of the fixed

capital accounts which will cease to indicate a clear-cut and definite fact, to wit, the cost of the capital in service.

§ 176. (4) Over- or Under-Statement of Maintenance to Be Avoided

Maintenance expenses are sometimes overstated by charges for new capital which should properly have been carried to the fixed capital accounts; on the other hand, they may be understated by the diversion to fixed capital accounts of repair or replacement charges which should have been made to operating expenses. Sometimes it is attempted to exclude temporarily repair costs from the statement of operating expenses for any one period by holding them in abeyance, charging them to a suspense account which will in the meantime appear among the assets on the balance sheet. Under very special circumstances this practice may be permissible, as for instance, when extraordinarily heavy expenses are incurred through unexpected and unusual casualties; it must be used with great care, however, for it can easily be made the means of deception.

§ 177. Accounting for Replacements of Capital

Repairs constituting maintenance must not be confused with replacements. The Uniform Systems of Accounts of the Public Service Commissions of New York define these terms thus:

“When through wear and tear or through casualty it becomes necessary to replace some part of any structure, facility, or unit of equipment and the extent of such replacement does not amount to a substantial change of identity in such structure, facility or unit of equipment, the replacement of such part is to be considered a repair, and the cost of such repair is to be treated as an operating expense and must not be charged as a replacement in capital accounts.

“Replacements include all substitutions for capital exhausted or become inadequate in service, the substitute having

substantially no greater capacity than that for which it is substituted. When a substitute has a substantially greater capacity than that for which it is substituted, the cost of a substitution of one of the same capacity as the thing replaced should be charged as a replacement and the remaining portion of the cost of the actual substitute should be charged as a betterment."

The practice contemplated in the above instructions carries the accounting for replacements through the capital accounts. The original cost of the capital replaced must be credited to capital account as having been retired, and the cost of the new and replacing capital must be charged at cost as having been installed. It is assumed that the company will have provided through its depreciation accounts for replacement to the extent of the cost of the capital retired, less the expected salvage. If the cost of the replacing capital is the same as that of the capital retired, the net effect of the accounting is the same as though the replacement had been carried through operating expense accounts altogether. If the cost of the new is greater, even though the article is exactly the same as that which it replaces, the excess cost goes to increase the investment in fixed capital. This practice has not gone unchallenged.

The replacement of the whole unit because it has become worn-out is not different from the replacement of its several parts, and it may be plausibly argued that if the replacement of the parts goes into operating expenses at cost of making the replacement, the cost of replacing the unit itself should be similarly treated. There is, however, a very good reason for distinguishing between the replacement of parts and the replacement of the unit. If cost is to be the basis of the capital accounts, then those accounts should show the last cost. If assets which originally cost \$100,000 on renewal have cost \$125,000, the increased cost should be charged to the fixed capital accounts so that the burden of the excess cost shall not be charged against the ratepayers of one period only, as would be the case if the costs were treated as costs of repairs, but be

distributed among the consumers of the service in which the new unit at its increased cost is utilized.

It is perhaps true that heretofore the more favored basis of accounting for replacements has been that which treats the cost of replacing in kind as an operating expense solely, no matter how much greater than original cost this cost of the replacing article may be. If there is any element of betterment, a proportion of the cost applicable to the betterment is properly subject to capitalization. The betterment must be represented by greater capacity, or perhaps by advanced construction which makes operations more economical. The test is that of an increase in earning capacity on the theory that, if the betterment is charged to capital, the expenditure will probably be met out of additional stock and bond issues. The increase in dividend and interest charges thus caused should be paid out of the earnings of the betterment.

CHAPTER XVII

ISSUE OF STOCKS AND BONDS FOR ACQUISITION OF FIXED CAPITAL

§ 178. Fixed Capital Classified

The Uniform Systems of Accounts prepared by the Public Service Commissions of New York divide fixed capital into landed capital and non-landed capital. "*Landed capital* includes all interests in land (exclusive of improvements thereon) the term of which is more than one year. All other fixed capital is herein called *non-landed capital*." They further divide non-landed capital into intangible and tangible, defining the terms as follows:

"*Intangible capital* comprises organization, franchises, patent rights, and all other intangible property within the definition of fixed non-landed capital as above stated. *Tangible capital* comprises structures and equipment having an expectation of life in service of more than one year."

§ 179. Capitalization for Acquisition of Intangible Capital

Under the head of intangible capital can be discussed in order: (1) organization expenses; (2) franchises; (3) patent rights; (4) contract rights and other intangible capital. These are intended to represent rights and claims conferring value upon the corporate enterprise; they are assumed to be capital in and of themselves, and not merely expenditures incident to the acquisition of physical property, so that they are not to be confused with expenditures on such items as engineering, interest during construction, etc. There are not included herein investments in stocks, bonds, commercial paper, and other evidences of interest which, although constituting

intangible capital in a broad sense of the term, do not come within the scope of the restricted sense in which the term is here used, to wit, capital used by the corporation in the rendition of a particular service.

The discussion of depreciation in Chapter XVI referred mainly to loss in value of the tangible capital in service. There is also depreciation of intangible capital. Where rights are limited to a number of years, the amounts charged to fixed capital accounts in respect thereof should be amortized during the life of such rights, unless it is expected that upon expiration they can and will be renewed. If that renewal may be accomplished without further expense, the original charge to capital accounts will remain as the cost of acquiring that right. If further expense is involved, the renewal cost could either be carried through the operating accounts or handled through fixed capital accounts, according to the method prescribed for the recording of replacements of capital.

§ 180. (1) Organization Expenses

These expenses are those which relate to the organization of the corporate structure itself, from the time that the idea is first suggested to the promoters and actively taken up by them, to the time when the incorporation has become an accomplished fact and its project has been launched; that is to say, until all necessary papers have been filed, the requisite authorizations acquired, prospective investors canvassed, stock and bond certificates prepared, sold, and delivered to the purchasers, and the proceeds entrusted to the corporate treasury. Later on, changes may occur in this corporate structure; its capitalization may be increased, its powers extended, etc.; and the expenses attending these changes will also become organization expenses.

All of the expenses here described are generally included under the head of intangible capital, but none of them represent costs which can be said to represent the acquisition by the cor-

poration of any property or other valuable rights. The corporation exists by virtue of a privilege extended to incorporators; the corporation itself may be said to be a franchise which belongs to the members of that corporation. Hence, the expenses of organizing the corporation are costs suffered by the incorporators and their successors in interest in perfecting and maintaining their claim to a privilege intended to be used for personal profit to themselves. That privilege is assumed to be valuable to its possessors, hence the exaction and the willing submission to the payment of an organization tax. In strict theory, therefore, there would seem to be no good reason why the stockholder should be relieved from these expenses. It is probably because of reasoning such as this that the German and Swiss laws specifically prohibit the inclusion of these items in fixed capital accounts, or their disbursement out of stock and bond issues, so that it is customary there to issue capital stock above par in order to collect an amount sufficient to cover the organization expenses; in effect, the stockholders are assessed for their proportionate share of the expenses.

In our public utility practice, however, there is very good reason for including organization expenses in the fixed capital accounts of the corporation. Even though it is an expense not producing actual assets to the corporation, and even though it is said to be wholly for the benefit of the individual stockholder, it is nevertheless an expenditure which is entitled to a return, since it has been incurred to establish the project. The emphasis that has been placed of late years upon the investment of the stockholders as a basis for rate-fixing tends to strengthen the warrant for the inclusion of organization expenses in capital accounts, so that the actual cost of the corporate project may be set forth. Since the profits of the enterprise accrue directly to the corporation, it is only fair that the corporation should assume the expenses incurred by incorporators in initiating that enterprise.

In spite of the fact that the right to be a corporation is a

privilege of the stockholders alone, it has not been uncommon for corporations to inflate their fixed capital accounts and capitalization by placing a high valuation upon "organization." Against that high valuation they would issue additional stocks and bonds to cover up accrued deficits, or else to declare and distribute dividends in the form of stock, scrip, etc. So common has been the use of this device that it has been thought necessary to make specific provision therefor. The New York Public Service Commissions law provides that "the Commission shall have no power to authorize the capitalization of any franchise to be a corporation." This prohibition has not been held to affect capitalization of the organization expenses.

Expenses of Effecting Corporate Organization. This group of organization expenses includes the cost of preparing the certificate of incorporation, including the compensation of attorneys and others, costs of recording, and all other costs incident to the perfection of the right to be a corporation. The organization tax which in New York and in practically every other state is required to be paid before or coincident with the filing of the certificate is also a part of these expenses. There are also included herein all costs, such as compensation of counsel and expenses of expert and other witnesses, of applications for authority to begin construction and to engage in business in the territory intended to be served. This last item of costs may sometimes reach high figures, especially if the application is opposed; nevertheless, if the applicant is successful, the total costs are chargeable to the fixed capital accounts under the prevailing rules, although it is quite probable that it is within the powers of a commission to require these costs to be amortized in whole or in part out of earnings. The contesting company, of course, if already operating, could not carry the expenses of the contest to capital accounts, even though it might be the successful party and secure its undisturbed possession.

Most of these expenses have become matters of record by the

time authorization for capital stock and bonds is granted, while the remainder may be almost exactly anticipated. There will thus be very little discussion concerning the amount to be included in the total sum to be provided for in the proposed capitalization.

It goes without saying that no duplication can be permitted in these accounts; for instance, a corporation which has merged another into itself cannot take over the organization accounts of that other and also charge to capital account the costs of effecting the merger. Neither may a consolidated corporation take over the accounts of the consolidating corporation and also charge to capital the costs of consolidation, even though in the latter case it is contended that the expenses of consolidation were incurred to secure definite operating economies so that they may be said to represent a betterment.

Expenses of Corporate Financing. The expenses attending the issue of capital stock are those incurred in the preparation of prospectuses; the commissions paid to underwriters; the costs of preparing certificates; etc. These are considered to be expenses of acquiring the permanent capital fund; the costs of the properties and rights acquired with the proceeds of the stock issue may therefore be said to have been increased by the expense of securing the issue of the stock, so that these costs may be charged to capital accounts.

The status of bond discount and expense is sometimes thought to be analogous to that of stock expense and chargeable to fixed capital accounts in similar manner. Such is not the fact, however; there is no unmistakable likeness. Bond expense includes the expenses of having the mortgage drawn up, titles searched, certificates prepared, etc., and the commissions paid to underwriters or brokers. The total bond discount and expense is a cost of borrowing, which some would have considered as identical in nature with the costs of acquiring the permanent capital fund through stock issues. The issue of stock is a necessary part of the organization of the

corporation; the borrowing of money is an incident in the operation of the fully organized corporation and is a transaction between it and third parties. The main distinction arises, of course, out of the limitation usually placed upon the life of the bonds, while the life of stock will be contemporaneous with that of the corporation. The bond discount and expense relating to issues of irredeemable bonds or those running for extra-long-term periods may very plausibly be charged to capital accounts in the same manner as expenses relating to the issue of stock.

The Uniform Systems of Accounts of the New York Public Service Commissions specifies that "discounts upon securities and other commercial paper issued in payment for capital are to be provided for in other accounts and must in no case be charged to the capital accounts." The method prescribed is in line with an interpretation of "cost of borrowing" to include both the interest actually paid upon the bonds together with the discount suffered, and the expenses incurred in the issue. The total bond discount and expense must be carried in suspense and amortized through income during the life of the securities to which they relate, so that for each year the interest payments plus the proportion of bond discount and expense charged off will represent the total payment for the use of borrowed capital. The accounting method has already been described in Chapter X.

Those who would treat bond discount and expense as identical with the expense attending the issue of stock, contend that these are costs of getting the tangible capital actually placed in service so that they represent just as much an investment as expenditures for rails or ties, buildings, etc. The American Street and Interurban Railway Accountants' Association, in reporting upon a standard classification of accounts prepared more or less in conjunction with representatives of the Interstate Commerce Commission in 1908, said: "The committee is uniformly of the opinion, that discounts and commissions on

securities issued for construction purposes, or to raise funds for construction, should be considered a proper capital expenditure and therefore to be charged to Expenditures for Road and Equipment." The Interstate Commerce Commission has apparently recognized some merit in this contention, or at least has not found sufficient demerit to condemn it *in toto*, since its accounting orders permit the charge to capital of "cost of printing certificates of stock and bonds, with payments to trustees and expenses incurred in the disposal of the securities."

In determining the amount of bonds necessary to be issued, the commission obviously must consider the price at which the bonds are to be sold in order to arrive at the gross amount necessary to be authorized. In passing upon the price of issue it will inquire fully into contracts with bankers or underwriters, require proof of market quotations for securities of similar character, and conduct any further inquiry to satisfy itself as to the reasonableness of the proposed price of issue. The discount to be suffered is thus fairly fixed in arriving at the capitalization to be authorized, while other expenses of the issue of stock or bonds can easily be ascertained.

Promoters' Fees. To many people payment of "promoters' fees" suggests the extreme of corporate sinfulness. There is no question that there have been instances which could not be described any more appropriately than by such characterizations, but there have also been innumerable instances where the promoters have conferred upon the public distinct and valuable service, for which they have been but ill repaid. The number of those who have spent their all, their very selves, in the development of enterprises which proved public boons but which brought naught but loss, reproach, and ruin to their promoters, is great indeed.

"Promotion has been so extensively abused and has been so universally used as a cover for abuses in capitalization that it has come to be regarded as a term of reproach and as a device to work schemes of robbery upon the investing pub-

lic. No reason is apparent why this should necessarily be so. The honest services of a capable promoter are indispensable to the flotation of every comprehensive and far-reaching scheme of development in the railroad world, or elsewhere. A clear vision to see opportunities, ability to demonstrate them to others, and energy to push to completion works untried but of great moment, are indispensable to material development and should be fairly and even liberally rewarded by the public which receives the benefit of those works. Such rewards, however, should be put upon a clear basis of business principle, should be of sufficient magnitude to encourage rather than discourage enterprise, and should not be so great as to make an exorbitant demand which is perpetual in its nature upon the community to be served. They are to be treated simply as just payments for services performed for the corporation, which services are valuable and in many cases even indispensable. Such services should be paid for upon the basis of what they are fairly worth, having regard to all the circumstances of the case. . . .

"It must be acknowledged, however, that there is no recognized scale of market values for the services of a promoter. Something should and must be allowed therefor if new enterprises in an untried field are to be encouraged and carried on. With no precedents to guide it, without the aid of any suggestions or arguments from outside, the Commission does not think it wise to lay down at this time any hard and fast rule to be observed by it in cases of this character. It seems probable that in the long run the best solution of the matter will be found in allowing a percentage upon the cost of the enterprise, such percentage, varying with the circumstances of the cases presented, to be sufficient to encourage rather than discourage legitimate work of this character, and yet not excessive or extravagant in any particular."¹

If the fees to promoters are paid in money, the actual

¹ Rochester, Corning, Elmira Tr. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 166 (177-178).

amount of payment may be charged to capital accounts; if payment is made in securities, then the par value of the securities should be capitalized. In the accounting classification the Public Service Commissions provide that capital may be charged with "the actual cash value at the time of organization of securities paid to promoters." There seems to be no reason, however, why a corporation should recognize anything else than the par value of its securities, unless part of the issue consists of bonds which by express agreement have been issued at a fixed per cent of par. Stock must of necessity be assumed to have been issued at par. After all, there were some meritorious aspects to the issue of founders' shares, so called, to the promoters. These made their compensation proportionate to the success of the enterprise.

The commission may inquire into the reasonableness of a contract between the directors and promoters for compensation, and it will allow only such an amount to be included in the capitalization as will appear reasonable, considering all the facts in the case. In allowing an applicant company to issue \$75,000 stock to promoters, where \$100,000 had been asked for, the Commissioner (of California Commission) writing the report said:

"I believe this project must be considered on its particular merits, as it does not come under the ordinary category of public utility enterprises. Here is an endeavor to construct a railroad for a distance of 43 miles into an undeveloped territory described as largely a desert country now very sparsely settled. It is a territory that does not yield gently to the hand of man, but requires pioneering, exploring, and development with unusual hazards and risks. There must, therefore, be the lure of unusual profits. I feel, also, that it is proper to take into consideration the benefit to the community of this State as a whole which will accrue through the construction of this railroad. It is trite to say that California is a land of vast possibilities awaiting development. Here is an extreme case

in point, where men have banded together to open up a whole section of this state—a principality in itself, long isolated and forbidding in its inaccessibility, difficulties and hazards.

"I recommend that Mr. Neeland and his associates be allowed \$75,000 par value of this stock, and this stock should be issued when the projectors have brought their enterprise to a successful conclusion by the completion of their track for the entire distance contemplated."²

§ 181. (2) Franchises

The franchises of a corporation are the privileges vested in and to be exercised by it, representing mainly rights to occupy streets, highways, and public places with railroad tracks, pipe lines, pole lines, etc. The franchises of a corporation do not include the right to be a corporation, which is a privilege conferred upon the incorporators and not upon the corporation. Quoting the New York Court of Appeals:

"The charter of a corporation is the law which gives it existence as such. That is its general franchise, which can be repealed at the will of the legislature. A special franchise is the right, granted by the public, to use public property for a public use, but with private profit, such as the right to build and operate a railroad in the streets of a city. Such a franchise, when acted upon, becomes property and cannot be repealed, unless power to do so is reserved in the grant, although it may be condemned upon making compensation. As we recently said:³ 'The general franchise of a corporation is its right to live and to do business by the exercise of the corporate powers granted by the state. The general franchise of a street railroad company, for instance, is the special privilege conferred by the state upon a certain number of persons known as the incorporators to become a street railroad corporation, and to construct and operate a street railroad upon certain conditions. Such a

² *In re California Southern R. R. Co.*, P. U. R. 1915-F. 311 (318).

³ *People ex rel. Metropolitan Street Ry. Co. v. State Tax Com.*, 174 N. Y. 417 (435).

franchise, however, gives the corporation no right to do anything in the public highways without special authority from the state, or some municipal officer or body acting under its authority. When a right of way over a public street is granted to such a corporation, with leave to construct and operate a street railroad thereon, the privilege is known as a special franchise, or the right to do something in the public highway, which, except for the grant, would be a trespass.'

"The right to be a corporation is frequently called a franchise, as it is in one sense, but not in the sense that the grant of a right to build a railroad in a public street is a franchise, and it is unfortunate that the same word is used with widely different meanings, for it leads to confusion unless qualified by an appropriate adjective, such as 'general' or 'special.' The right to be a corporation, or the corporate right of life, is inseparable from the corporation itself. It is part of it and cannot be sold or assigned. That franchise is general and dies with the corporation, for it cannot survive dissolution or repeal. On the other hand, grants to do something in the public streets, or special franchises are not a part of the corporation. They can be made to an individual with the same legal force or effect as to a corporation. Unless there is some legislative restriction, they can be mortgaged and sold. They are no part of the corporate life, if owned by a corporation, any more than they are a part of the individual life if owned by a human being."⁴

Cost of Acquiring Grant. The capitalization of franchises has occupied a large place in the general abuse to which the capitalization of intangibles has been subjected; they have been taken into the capital accounts at high values against which to issue stocks and bonds. There can be no doubt that if a corporation has been required to pay for a franchise or has been subjected to any cost in acquiring it, it will be wholly proper to charge such costs to the capital accounts. It is worth while

⁴ Lord v. Equitable Life Assn., 194 N. Y. 212 (226).

to note in passing that the usual method of selling franchises is an illogical and short-sighted expedient, to be justified only upon the theory of indirect taxation, for those who are supposed to receive the benefit of the purchase price are the same persons who always thereafter will be required to pay a rate for service which will include a fair return on the purchase price paid by the corporation.

Legislation has been necessary to discontinue the practice of issuing securities against inflated values placed upon franchises. The Public Service Commissions Law of New York provides that "the commission shall have no power to authorize the capitalization of any franchise or the right to own, operate or enjoy any franchise whatsoever in excess of the amount (exclusive of any tax or annual charge) actually paid to the state or to a political subdivision thereof as the consideration for the grant of such franchise or right."

Conditions of Grant Involving Annual Expense. In granting franchises municipalities have often imposed, in addition or in lieu of a present consideration, various requirements which subject the corporation to annual expense on account of the franchise. They have demanded, for instance, a proportion of the gross earnings, or the rendition of a certain amount of free service, such as free lighting of municipal buildings. Of course, this means that the users of the service must pay just so much more to compensate the utility for the cost of the free service rendered or the percentage of revenue turned over. In every case the utility is entitled to demand rates which will permit an adequate return upon the property after the deduction of these costs and payments. Public Service Commissions almost uniformly have condemned such reservations on the part of municipalities, and have considered the rendition of free service as clearly discriminatory, while the New Jersey Supreme Court has held that the provisions of the public utility law prohibiting discriminatory contracts apply with full force and effect to contracts with municipalities.

Corporations have sometimes attempted to capitalize the future expense of franchise obligations, i.e., to issue securities against the present worth of the sums required to be paid periodically during the life of the franchise, or of the value of the services to be rendered. In an application before the Public Service Commission, Second District, it was proposed thus to capitalize the franchise obligations of an electric company which was required to furnish free current. The value of the current delivered free under the franchise provisions had been amounting to about \$4,000 each year, and on that basis the total expenditure for the balance of the term of the franchise was estimated at about \$188,000, for which amount securities were sought to be issued. Authorization was refused, the Commission holding that no other course was open to it in view of the prohibition of the statute against the capitalization of any franchise "in excess of the amount (exclusive of any tax or annual charge) actually paid as the consideration for the grant of such franchise." The Commission holds that: "The only possible meaning to attach to the language 'exclusive of any tax or other annual charge' is that the annual charge cannot be capitalized." It explains the general proposition as follows:

"If a corporation pays a municipality a fixed sum for a franchise at the time it is granted, it is clear that the sum so paid may be capitalized by the issue of stock to that amount. The question has been raised, why a deferred payment may not also be capitalized. That is to say, if instead of paying a fixed sum at the outset the corporation is required to pay in cash or service a certain amount each year during the continuance of the franchise, why may not stock to the same amount be issued to represent such payment?

"Stock issued to a person is an evidence that he has advanced money, property, or services to the corporation upon which he is entitled to a return by way of dividends earned and to a part of the assets of the corporation in case of its disso-

lution. When the corporation pays a fixed sum as consideration for a franchise it must derive the money either from surplus or someone must advance it to the corporation. In the latter case, either stock or bonds may be issued to the person advancing the money. . . . If the money be paid from surplus, obviously neither stock nor bonds can be issued since no one other than the corporation is entitled to them. The corporation by making the payment with its surplus merely changes the form of the surplus from cash to franchises. . . .

"In case of a deferred payment, for cash or service, no person at the time the franchise is granted makes any advance either to the municipality or to the corporation of money, property, or services, and hence no person is entitled to either stock or bonds. . . .

"The underlying principle is that whatever a municipality receives from a corporation for a franchise may be added to the charge for service. If the payment is made annually in either money or service, the corporation may recoup itself directly from its customers in that year. If the payment is made in a lump sum at the time of granting the franchise, the amount paid must be spread over all the bills for the entire term of the franchise. This can only be done by issuing stock or bonds to the persons advancing the money paid and making annual return to them by way of dividend or interest. Such dividend or interest is spread over the annual bills, and in this way the customers of the company pay just what they ought to pay and no more." ⁵

Costs of Procuring Assignment of Franchises. Where a franchise is acquired through purchase or assignment, the full amount paid for its acquisition can be capitalized. The transfer of a franchise is now subject to the authorization of the Commission, which will inquire into the consideration to be paid and the manner of payment, so that the danger of overcapitalization is slight. As a matter of fact, in the initial development

⁵ *Genesee Light and Power Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 487.

of a corporation few franchises are acquired directly; most of them being granted to the incorporators who later turn them over to the corporation. It goes without saying that where a franchise is acquired by an individual on behalf of a corporation about to be formed, the charge to the corporation should be no greater than the actual cost to the immediate grantee.

Accounting Requirements. The text of the fixed capital account "Franchises" in the Uniform Systems of Accounts of New York is as follows:

"To this account shall be charged 'the amount (exclusive of any tax or annual charge) actually paid to the State or to a political subdivision thereof as the consideration for the grant of such franchise or right' (Section 69 of Public Service Commissions Law) as is necessary to the conduct of the corporation's electric operations. If any such franchise is acquired by *mesne* assignment, the charge to this account in respect thereof must not exceed the amount actually paid therefor by the corporation to its assignor, nor shall it exceed the amount specified in the statute above quoted. Any excess of the amount actually paid by the corporation over the amount specified in the statute shall be charged to the account 'Other Intangible Electric Capital.' If any such franchise has a life of *not more than one year after the date when it is placed in service*, it shall not be charged to this account but to the appropriate accounts in 'Operating Expenses,' and in 'Prepayments' if extending beyond the fiscal year.

"Payments made to the state or to some political subdivision thereof as a consideration for granting an extension for more than one year of the life period of a franchise shall be classed as renewals. Those made as a consideration for franchises or extensions thereof covering additional territory to be operated as a part of an existing system shall be classed as betterments. If the franchises cover separate and distinct new enterprises, the payments therefor shall be classed as original.

"Note.—Annual or more frequent payment in respect of

franchises must not be charged to this account but to the appropriate tax or operating expense account."

In respect to the matters referred to in the note, there is included in the operating expenses an account entitled "Franchise Requirements," which, for electrical corporations, reads as follows:

"Charge to this account the cost of all energy and materials and supplies furnished to municipal corporations in compliance with franchise requirements and for which no payment is received by the corporation; also of all direct expense, such as paving and other like matters, incurred in compliance with such requirements and for which no reimbursement is received by the corporation. Amounts charged to this account for which there is no direct money outlay shall be credited to the below provided account 'Duplicate Electric Charges—Credit.'"

This account is introduced into operating expenses to obviate a credit to revenue for the assumed value of the services rendered.

Where franchise rights may not be exercised without the prior authorization of a state commission, an interesting situation arises where a corporation secures a franchise for a valuable consideration, say, payment of \$2,000. It may capitalize that sum if the franchise is ratified by the commission, but would it be proper so to capitalize it if the commission refuses to sanction the exercise of powers thereunder? There will then be no operations to which the annual return upon that payment may be charged, and it will not be fair to assess against the customers in one municipality the annual burden of an alleged capital expenditure which actually accrued to the benefit of another municipality. Manifestly, the payment cannot be capitalized under these circumstances but must be written off through the surplus account as a loss to the stockholders. As a matter of fact, the corporation will protect itself through an agreement that it will be relieved from the obligation to take the franchise if it is not ratified.

§ 182. (3) Patent Rights

The capitalization of patent rights is not of very much importance in the public utilities field, since patents for new appliances or processes are usually acquired by manufacturing corporations. If patent rights are obtained by a public utility pertaining to appliances or processes to be used in its own operations, the amount paid for the patent may be charged against its fixed capital accounts and securities issued against it; or if the patented article has been originated through the research department and by the employees of the corporation itself, all of the expenses of developing the idea, and the fees and other expenses incurred in securing the patent, could be so charged.

The text of the account "Patent Rights" as contained in the Uniform Systems of Accounts of New York is as follows:

"Charge to this account the cost of all rights (having a life of more than one year from the date when placed in service) acquired by the corporation in or under valid patents granted by the United States to inventors for inventions and discoveries which are necessary to the economical conduct of the corporation's street railroad operations. If any such rights are extended to cover a further period of time than that covered by the original grant, the cost of such extension shall be classed as a renewal. A patent right acquired for use in an existing system and necessary to the economical operation thereof shall be classed as an addition."

§ 183. (4) Contract Rights

The capitalization of the assumed value of a contract giving to the corporation some specific right or claim through which revenue accrues to it, or which confers some benefit upon the corporation, has been quite usual. It has been so often used as a device for fictitious capitalization, however, that the practice has fallen under condemnation and such an item in the fixed capital accounts will be scrutinized very carefully before its

propriety will be admitted. Under exceptional circumstances, where a valuable contract is secured, promising a clear and substantial benefit to the owner so that it may be reasonably considered to constitute a valuable asset, the cost of its acquisition, e.g., the purchase price if a payment was made for its acquisition, or fees and commissions paid in the course of negotiation and acquisition, may be charged to capital accounts and securities issued against it. But the amounts so charged should be amortized during the life of the contract and out of the earnings accruing from its use. (See § 184.)

The Public Service Commissions Law of New York provides: "Nor shall any contract for consolidation or lease be capitalized in the stock of any corporation whatever; nor shall any corporation issue any bonds against or as a lien upon any contract of consolidation or merger." The prohibition relates to a class of contracts the capitalization of which was frequently resorted to for the purpose of introducing water into the capitalization, and which was wholly unsupported by any excuse or warrant for its inclusion in capital accounts. Concerning other kinds of contracts there is no specific provision in the law, neither has any rule governing the matter been carried into the accounting classifications.

In *Fuhrmann v. Cataract Power Co.*,⁶ a rate case, the company sought to include in the value of its fixed capital \$2,000,000 as the value of certain contracts with the Niagara Falls Power Company under which it was privileged to purchase from the latter "for over a thousand years at least 37,500 horse-power at the rate of \$16 per horse-power per annum." The company's contention as to the value of the contract and the propriety of capitalizing that value were stated as follows in the brief of its counsel:

"With the evidence undisputed in the record that there is a demand on the part of the consumers at Niagara Falls for power at \$20 per horse-power per annum; that the cost of

⁶ 3 P. S. C. Rep. (2nd D., N. Y.) 656.

transmitting power to the Buffalo city line is approximately \$4 per horse-power per annum, making a total cost here of \$24 per horse-power per annum, assuming that there were any Falls power available, which is not the fact; with the undisputed testimony in the record that the cost of generating electric power in Buffalo with the most modern steam plant would range from \$25 to \$28 per horse-power per annum, can it reasonably be questioned that this contract, requiring the delivery of 37,500 horse-power at the city line every year during the term of the Cataract's franchise (nineteen years yet to run) and beyond for upward of a thousand years at the rate of \$16 per horse-power has a value? Clearly not. How then should such value be arrived at?

"Assuming the market value of hydro-electric power at the Falls at \$20 per horse-power per annum, and assuming \$4 per horse-power per annum as the cost of transmission to the Buffalo city line, we have \$24 per horse-power per annum as the market value of Falls power at the Buffalo city line, assuming there were any available.

"Applying the other test as to the cost of generating electric power by a modern steam plant in Buffalo, we have \$25 to \$28 per horse-power as the lowest estimate for the cost of steam generation. It is apparent, therefore, that the only logical way of arriving at the value of this contract is by taking the difference between the cost of power under the contract and the cost of power generated here by steam. The difference is \$9 per horse-power per annum. Multiply this by the 37,500 horse-power which the power company is required to deliver us, and we get the annual saving of \$337,500 per annum. This sum capitalized at 8 per cent would be over \$4,000,000."

In contending for a valuation of \$2,000,000 instead of \$4,000,000 the company claimed to be dividing with the public the benefits of the conceded fact that Niagara-generated power was cheaper than steam-generated power. In the words of the principal witness for the company: "My conclusion is

that it is fair to all parties to divide the advantages of hydraulic generated electric power between the public and the people whose enterprise makes the utility of the hydraulic power by this process."

The Commission refused to allow any valuation whatever for the contract on the ground that the value of the contract depended upon the price which the company would be permitted to collect for its service; if the price of \$25 per horse-power on which it based the profit of \$9 per horse-power were reduced, the supposed value of the contract would be correspondingly decreased.

"No generating company using the water of Niagara river owns those waters or has any right or title to them whatsoever. By the permission of the Federal Government and of the State of New York, the generating companies operating at the Falls are given the free use of those waters in the production of electric energy. To say that by having been given the free use of those waters for that purpose they are vested with an unassailable right to charge as much for the electric energy developed as they would for energy developed by steam plant, is a proposition which requires to be maintained rather than to be refuted. It may very well be that these companies are entitled, in view of all of the circumstances of the case, to a liberal return upon the capital actually invested in developing the energy. It may very well be that the people exploiting the enterprise are entitled to large, and even very large, profits for the skill they have displayed and the risk to which they have subjected their capital. It may be that the public ought to pay them very liberally for the work which they have carried on in the public interest; but to say that the public is entitled to no advantage from the use of these waters, that the territory which can be served with electric energy developed at Niagara Falls has no advantage and is entitled to no benefit by reason of proximity to those Falls, is to say something which does not appeal to the best judgment of mankind for an instant.

"We may therefore dismiss without further consideration the claim of the company that its contract with the Niagara Falls Power Company has a value of \$2,000,000 upon which it is entitled as a matter of right to a return of not less than 6 per cent per annum; and the question of what return it is entitled to, if any, in excess of the cost of steam generated electric energy, is one which may be considered in another connection."

§ 184. (5) Other Intangible Capital

The text of the account "Other Intangible Capital" in the Uniform System of Accounts for Street Railroad Corporations, New York, is as follows:

"Charge to this account the cost of all other property coming within the definition of intangible capital and devoted to street railroad operations. All entries of charges to this account shall describe the acquired property with sufficient particularity clearly to identify it, and shall also show specifically the principal from whom acquired and all agents representing such principal in the transaction; also the term of life of such property, estimated if not known, and if estimated, the facts upon which the estimate is based."

This account has often been used, and is intended to be used, in a manner approaching the use of the account "Good-will" in ordinary private enterprises. It has been definitely established that "Good-will," as the term is understood, cannot exist in the case of public utilities which represent, in the main, natural monopolies. It has been the accounting practice, however, in relation to other classes of corporations to charge to a "Good-will" account the excess of consideration paid for a plant or a going business acquired by the accounting corporation over the actual value of the physical assets coming into its possession. A like function is performed by this account "Other Intangible Capital," as explained hereinafter under the heading "Purchase of Plant," § 187.

**§ 185. Capitalization for Acquisition of Tangible Capital—
(1) Construction**

The greater part of the capitalization of public utility corporations represents expenditures for "structures and equipment having an expectation of life in service of more than one year," i.e., for the acquisition of tangible capital, and in by far the greater number of instances these expenditures are those made by the corporation itself for construction of its own plant rather than the purchase thereof from others.

In considering an application for authorization to issue stocks and bonds the proceeds of which are to be used for construction, the determination of the amount to be allowed by the commission will resolve itself into the determination of what the construction will cost. Whether the plant shall be built or not, that is, the question of the company's entrance into that particular territory, will already have been determined.

The probable cost of construction is an estimate, of course, and only approximate, unless it is proposed to have the work performed by contractors under an agreement so definite in its terms that the cost to the public utility corporation will be fixed beyond the possibility of any change. Usually the actual cost will be more or less than the estimate, either through changes in the character of the originally proposed construction, or through fluctuations in the prices of materials and the wages of labor during the construction period, or else through unforeseen accidents which delay the work and thus increase the overhead expenses. The considerations necessitated by these circumstances are thus stated by the Public Service Commission for the Second District of New York:

"It follows . . . that an order establishing the capitalization of a new enterprise should be sufficiently flexible to allow of additional capitalization if properly required to complete the work. It also follows that if the spirit of the law is to be observed, any such order should so hedge about the issue of stock and bonds with just and reasonable restrictions

that it will be practically impossible for a company to secure more capitalization than is actually necessary for the purposes contemplated by the Commission in granting the authorization, and that if the original estimate and allowance are too great the actual issue may be restricted to such sums as are necessary and at the same time ensure the completion of the work according to the plans and specifications submitted by the applicant to the Commission.”⁷

Proper restrictions upon the issue of stocks and bonds authorized for construction purposes are not difficult to devise or to adapt to particular cases. They should be such that, coupled with the commission’s control over the accounts and its power to inspect the plant and equipment, the danger of manipulation of estimates and costs may be obviated; such, for instance, as an attempt to cheapen or restrict the construction first proposed so as to leave a balance of unexpended proceeds of the authorized issues to be devoted to purposes other than those contemplated in the authorization.

All the comments made in foregoing pages concerning the detail to be observed in fixed capital accounting, the basis upon which entries should be made, etc., apply most directly to the record of construction expenditures. It should be possible from these accounts to tell not only the actual and complete cost of the plant as a whole but also of each separate facility. A glance at the list of accounts enumerated in the Uniform Systems of Accounts will indicate the separation of expenditures to be recorded upon the books. Taking, for example, the extended⁸ classification for electric railroad corporations, there will be found five groups of accounts: “Roadway,” “Electric Line,” “Buildings and Structures,” “Power Plant

⁷ Rochester, Corning, Elmira Traction Co., 1 P. S. C. Rep. (2nd D., N.Y.) 166 (179).

⁸ The New York Public Service Commissions have classified the corporations subject to their jurisdictions and have issued separate accounting systems for the different classes. Electric railroad corporations with annual gross operating revenues above \$500,000 have received the extended accounting order; those with annual revenues of less than \$500,000 and over \$100,000 have received a condensed classification, and those with revenues of less than \$100,000 have received one still further condensed. Electrical and gas corporations are similarly classified, but a classification still further condensed is provided for those with revenues of less than \$25,000.

Equipment," "Rolling Stock and Miscellaneous Equipment." In the first group, "Roadway," there are fifteen accounts—Grading, Ballast, Ties, Rails, Special Work, Underground Construction, Track Laying and Surfacing, Paving, Roadway Tools, Tunnels, Elevated Structures, Bridges and Trestles, Crossings and Signs, Interlocking and Other Signal Apparatus, Telephone and Telegraph Lines. These accounts must be kept separately. Under the second group of "Electric Line" there are four accounts to show separately the cost of poles and fixtures, underground conduits, transmission system, and distribution system. Under the third group, "Buildings and Structures," there are eight accounts for the expenditures on: Dams, Canals, and Pipe Lines, Power Plant Buildings, Substation Buildings, General Office Buildings, Shops and Car Houses, Stations, Docks and Wharves, Park and Resort Properties. There are eight accounts in the group "Power Plant Equipment," and six in the group "Rolling Stock and Miscellaneous Equipment."

The cost to be recorded in each account should be the complete cost, including, in addition to the labor and material directly applicable, such proportions of other general and overhead expenses as may be properly assignable to that account. These general and overhead expenses very often are difficult of apportionment, however, and for that reason separate accounts are provided wherein unapportioned expenditures may be recorded. The text of these accounts in the Uniform Systems of Accounts of New York indicates their nature very clearly.

"Engineering and Superintendence. Charge to this account all expenditures for services of engineers, draughtsmen, and superintendents employed on preliminary and construction work, and all expenses incident to the work when such disbursements cannot be assigned to specific construction.

"Note. When employees enumerated above are engaged in work not chargeable to construction, their pay and expenses shall be charged to the specific work on which engaged.

"Law Expenditures During Construction. Charge to this account general expenditures of the following nature, incurred in connection with the construction of a road, namely: the pay and expenses of all counsel, solicitors, and attorneys, their clerks and attendants, and expenses of their offices; printing briefs, legal forms, testimony, reports, etc.; payments to arbitrators for the settlement of disputed questions, costs of suit and payment of special fees, notarial fees, and witness fees; and expenses connected with taking depositions; also all legal and court expenses.

"When any of the expenditures above enumerated can be charged directly to the account for which incurred, they shall be so charged and not to this account. Expenditures in connection with the acquisition of the right of way or other land shall be charged to account 'Right of Way,' or account 'Other Street Railroad Land,' according to the character of the land acquired. Law expenditures in connection with the organization of the corporation shall be charged to account 'Organization.'

"Injuries During Construction. Charge to this account all expenditures incident to injuries to persons when caused directly in connection with construction of road and equipment; proportion of salaries and expenses of physicians and surgeons; nursing and hospital attendance, medical and surgical supplies, artificial limbs, railroad and carriage fares for conveying injured persons and attendants; funeral expenses (including payment to undertakers); proportion of pay and expenses of claim adjusters and their clerks, and pay and expenses of employees and others called in consultation in relation to the adjustment of claims coming under this head; also witness fees and amount of final judgments.

"Taxes During Construction. Charge to this account all taxes and assessments levied and paid on property belonging to the corporation while under construction and before the road is opened for commercial operation, except special taxes

assessed for street and other improvements, such as grading, sewerage, curbing, guttering, paving, sidewalks, etc.; which shall be charged to the account to which the property benefited is charged.

"Miscellaneous Construction Expenditures. Charge to this account the salaries and expenses of executive and general officers of a road under construction; clerks in general offices engaged on construction accounts or work; rent and repair of general offices when rented, with the furniture and office expenses; insurance during construction; also all construction and equipment items of a special and incidental nature which cannot be properly charged to any other account in this classification.

"Note A.—This account may include a suitable proportion of store expenses when such expenses are not assignable to specific materials.

"Note B.—This account shall not include any costs of organization, or any costs or discounts connected with the issue or disposal of stocks, funded debt, or other securities and commercial paper.

"Interest During Construction. Charge to this account the interest accrued upon all moneys (and credits available upon demand) acquired for use in connection with the construction and equipment of the property from the time of such acquisition until the construction is ready for use. Interest receivable accrued upon such moneys and credits shall be credited to this account. To this account shall also be credited discounts realized through prompt payment of bills for materials and supplies used in construction, unless such discounts are credited to the particular bills."

In determining the amount of capitalization to be allowed to cover construction and related costs, expenses of the nature above described are only partly capable of proof. For instance, the interest during construction is a matter which can be computed fairly well barring undue prolongation of the work, but

in greater part they are estimated approximately only and are based upon the experience gained in similar projects. Although at times the estimates for each class of expense will be specifically enumerated, in most instances the whole amount necessary to cover all of such expenses is allowed for on the basis of a percentage of physical construction costs.

But for how long a period may the salaries of general officers and other expenses, or the interest paid upon bonds and loans, and the other disbursements above described be charged to capital account, i.e., be designated and set aside as an investment upon which the company should be allowed to earn a return? The propriety of charging these items to capital arises in the first instance from the fact that they are incidents of construction costs. But when is the justification removed so that by their very nature they must be required to be charged against operations? The question suggests its own answer in a general way; if there are no operations, certainly no expenses can be charged up against them. It may be, however, that the lack of operations is not due to the construction being unready, but to some other cause for which the company is responsible and over which it has full control. Such circumstances would be exceptional, however, and where they are found to have been wilfully produced the corporation will certainly be required to set up the expenses in a separate account to be charged against earnings after operations have been commenced.

The greatest difficulty is experienced where operations and construction are intermingled. Suppose a road is under construction between two points; as the road is completed to each intermediate station along the route, the company extends train operation to that station. The problem for solution is whether all interest payments, for instance, shall be considered as no longer applicable to construction costs but to be charged against the operations, even though operations pertain only to a part of the proposed construction, or shall they continue to be

charged in totals against capital, or, again, shall there be an apportionment and a part charged to operation and the remainder charged to the construction? The answer will depend very much upon the nature of the project. If the section which has been completed can be considered to be a separate division or an operating unit, its construction period will be deemed to have been closed as soon as operations were instituted. If that section cannot be so considered, however, and the operation of other parts not yet completed is essential to carry out the original intent, incidental operations do not affect the construction period. Aside from theoretical considerations, it will be the best policy to charge some part of the interest against the operations of completed parts, if for no other reason than that of reflecting the actual costs of operating those parts. So much of the expenses of clerical labor, superintendence, etc., as are directly caused by the conduct of operations must necessarily be properly segregated and charged to operating expenses. Apportionment of other overhead expenses and the charge of a part to operating expenses should be carried out even though the net result of operations is a loss.

If the loss from incidental operations during construction period should prove considerable, under some circumstances it will be quite proper to charge all or a part of it to the fixed capital accounts. In many quarters "development expenses" are held to be eminently proper charges to capital under all circumstances, but it is undoubtedly the better practice to consider accumulated deficits chargeable to capital as the exception and not the rule. Deficits not chargeable to capital may be set up as a deferred debit and wiped out through annual appropriations from the earnings of the business after operation of the entire plant is put under way.

The charge against capital account for interest during construction should be the amount of the actual interest expense incurred by the corporation. This seems an elementary rule; it is the practice prescribed by the accounting rules. Neverthe-

less, there is some merit to the argument that there will be circumstances where the uniform application of this rule will result injuriously to the public interest. One may find two similar plants constructed under almost identical conditions, but the one will have recorded interest charges much greater in proportion to the total costs than the other. The reason may be simply that the one plant has constructed its plant mostly out of the proceeds of bonds, while the other preferred to issue more stocks than bonds. Or the reason may not be quite so simple; it may be that the rate of interest paid was excessive, not because of the market conditions or the lack of credit, but rather because of the attempt to favor certain creditors who are affiliated with those seeking to exploit the corporate project. Sometimes where the interest rate could not be questioned, objection is taken to the amounts borrowed; it will be claimed that more money had been borrowed than the construction immediately in hand had warranted. As a matter of fact, there will be very few instances in actual practice where these questions will be of anything more than academic interest; only in "reproduction cost" valuations will any serious attention need to be devoted to the problems of interest charged to construction accounts.

It is not usual to carry provisions concerning such problems into the statutory law. In a federal bill proposed some years ago in relation to regulation of capitalization by the Interstate Commerce Commission, there had been inserted the following provision:

"Where any securities of such corporation are issued for the purpose of raising money or to defray the expenses of the construction of any permanent line for transportation or for the transmission of intelligence which cannot be made profitable over a lengthened period, the company may pay interest on so much of the cost thereof as is hereinafter specified out of the proceeds of its stock, charging the same as part of the cost of construction. But no such interest shall be paid out of

the proceeds of stock unless the same shall have been expressly authorized by the Interstate Commerce Commission as necessary for the purpose of enabling such construction to be made, and the Interstate Commerce Commission shall determine for what period of time interest may be paid in this manner, and such period shall in no case extend beyond the close of the half year during which the construction shall have been actually completed."

§ 186. (2) Construction Under Contract

There would seem to be no special problem presented in the matter of capitalization by reason of the fact that the public utility corporation chooses to have its plant built by contractors rather than by its own forces; in fact, the greater proportion of railroads and utilities are now built by contractors, and no questions are encountered either in accounting or as to capitalization. The instances which have presented serious difficulties are those where the device of interior construction companies have been used, i.e., where a corporation has been organized for the specific purpose of building the plant under a contract from the utility company, both companies being under the same management and intimately related to each other through the identity of officers and employees who render like services for both. The existence of two companies is a matter of form more than of substance, and it is a device very frequently used to pervert the provisions of laws governing the issue of stocks at par for cash or only for labor done or property actually received. The construction company receives the contract under an agreement that it shall accept payment in stocks and bonds. The par value of the stocks and bonds may be so much in excess of the probable cost of construction as to make it self-evident that the stock is being issued at a price much less than par, or perhaps for nothing at all and simply as a bonus to accompany the bonds, while the proceeds of the latter, even if issued at a great discount,

are counted upon as sufficient for the cost of construction. Two very good-sized birds could be killed with this stone: First, the stocks and bonds could be marketed upon almost any basis at all, wholly irrespective of statutory restrictions or prohibitions, with the incident of large profits accruing to those who as officers of the public utility corporation issued stock to themselves as officers of the construction company and later sold them upon advantageous terms. Second, the public utility corporation can claim plausibly enough that the cost to it for the completed plant has been the par value of the securities issued, and it will so record the transaction, avoiding a number of perplexing problems as to treatment of discounts, etc., which would otherwise confront it.

The provisions of public service commissions laws have placed a substantial check upon the abuse of construction companies. The Public Service Commission for the Second District of New York characterized the practice as the employment of devices "which will at all times receive the condemnation of this Commission so far as it has any power or jurisdiction in the matter."⁹ No objection can be taken, of course, to the employment of bona-fide construction companies, even though payment be made in whole or in part by the issue of securities. Where the transaction is in good faith, the treatment of the cost of construction carried on under contract will be similar to the method of recording costs of construction in the ordinary way or else of recording the purchase price of completed plant or portion of plant.

If the projected plant is to be built by contract, the terms of the contract will be placed before the commission for consideration in arriving at the amount of stock and bonds to be authorized. The commission will inquire fully into the contract and the questions which arise will be practically those attending the estimate of construction costs with the added

⁹ Rochester, Corning, Elmira Traction Co., 1 P. S. C. Rep. (2nd D., N. Y.) 166 (189).

item of contractor's profits. The last item is a perfectly legitimate one, and a liberal allowance therefor is often more to the public advantage than would be the case if construction by contractors were discouraged and operating companies were required to build their own plants. Of course, there must not be any duplication of profits; an allowance should be included only where the utility company is to be billed at cost by the contractor; thus, a contract which specified fixed prices to be charged by the contractors for the several parts of the construction work, to be increased by an allowance for profit, was condemned because of the possibility that the fixed prices might also include or result in a profit. The manner of recording the cost upon the books should be just the same as though the company was doing its own work rather than having it done by contractors, and it will therefore be necessary that the former stipulate that the contractors shall furnish detailed statements of costs.

There may be instances where the construction contract had become effective before it came to the commission's notice; for instance, it may have been executed before the enactment of regulating statutes and the application in connection with which it is presented for consideration is one to issue the stocks and bonds necessary to carry out the terms of the contract. The commission cannot exercise any authority over the contract, and the situation which it confronts is one where obligations have become fixed; it will, nevertheless, be justified in examining the terms of the contract and inquiring into actual costs and disbursements so as properly to safeguard and protect its authorization. It may even consider the application as identical with one to issue securities for the purchase of a plant and apply like rules for ascertaining values. The accounting method also will follow that for recording the cost of the purchased plant if the detailed costs of the construction thereof are not available to the corporation making the accounting.

§ 187. (3) Purchase of Plant

An application to issue stocks and bonds for the purchase of a completed or going plant is subject to somewhat different considerations from those already discussed; these differences are due mainly to the fact that the determination of the amount required deals with a present value instead of a cost. The purchase price is the cost to the purchaser, of course, but it may be much in excess of, or less than, the actual cost of the purchased plant. We are dealing at this point with the transfer of a plant already serving a like purpose or readily adaptable. Moreover, the actual transfer of a physical property by deed of sale is contemplated and not the devolution of control which may follow the acquisition of a majority of the stock of another company, or the automatic transfer of title incident to mergers, consolidations, etc. The transfer by deed incident to reorganization is dealt with in a succeeding chapter.

In most of the states where effective regulation prevails commissions are given very complete supervision over the transfer of the plant of one company to another. The express approval of the commission is usually necessary before the transfer can be made effective. Necessarily the finding that the proposed transfer does not contravene public policy is a condition precedent to the determination of the amount of securities to be authorized for issue by the purchasing company. The principles of public policy which obtain here are substantially the same as in the case of consolidations and incorporate relationships in general, discussed in Chapter XVIII.

Negotiations for the sale and purchase of a plant are apt to cover a long period of time before the minds of the interested parties meet and the terms are fully agreed upon and a contract executed. Not until then is the commission asked to authorize the transfer and the issue of securities necessary to give it effect. Both requests will usually be heard and decided together. The contract is not binding upon the commission,

and the reasonableness of its terms may be inquired into very fully. Where the contracting parties are unrelated and the negotiations have been bona-fide, the commission will find some difficulty in case of doubt as to the reasonableness of the terms, for there may be many situations where the price to be paid is admittedly more than the property is worth, and yet the vendor will not sell it for less; while, if authorization should be withheld, an undertaking which might have proved very beneficial to the public will be discouraged and abandoned. Where the parties are related, for instance, and both are corporations controlled by the same interests, the "moral suasion" of the commission, together with the suggestion that authorization may be withheld, will often prove sufficient to secure amendment of the terms of the contract to conform with the commission's determination of the value of the property and the reasonableness of the price to be paid and included in the capitalization of the vendee. The principles which govern the inquiry into the reasonableness of the purchase price are in general the same as underlie all valuations of property for capitalization purposes.

If the application for authority to make the transfer is heard and decided independently, upon a subsequent hearing with reference to the issue of securities the contract may be brought forward as conclusive of the amount necessary to be realized through capitalization. If the commission in its approval of the transfer had knowledge of the proposed purchase price and the medium of payment, i.e., issue of stocks or bonds direct to the vendor, it must recognize the force of that contention unless it later finds something in the corporate and financial status of the purchaser which justifies a direction that the necessary amount be procured otherwise than by the issue of stock or bonds.

The method of recording the purchase in the capital accounts is governed by the following instructions of the Uniform Systems of Accounts of New York:

"When any road or other fixed capital in the form of a going or completed plant is purchased, an appraisal of such capital so acquired shall be made, and the different constituent elements of the road (and equipment, if any) or other capital acquired shall be appraised at their structural value; that is to say, at the estimated cost of replacement or reproduction less deterioration to the then existing condition through wear and tear, obsolescence, and inadequacy. If the actual money value of the consideration given for the road or other capital was at the time of the acquisition in excess of such appraised value, the excess shall be charged to the account 'Other Intangible Street Railroad Capital,' and the appraised values of the constituent elements shall be charged to the appropriate accounts as designated in the following definitions of accounts for expenditures for road and equipment and other fixed capital. If the actual money value of the consideration given was not in excess of such appraised value, such actual money value shall be distributed through the said accounts in proportion to the said appraised value of the constituent elements appropriate to the respective accounts. Full report of the contract of acquisition, the consideration given therefor, the determination of the actual money value of such consideration, the appraisal, and the amounts charged to the respective accounts for each road or other fixed capital purchased, will be required to be made to the Public Service Commission, and the purchaser will be required to procure in connection with the acquisition of any such road or other fixed capital all existing records, memoranda, and accounts in the possession or control of the grantor relating to the construction and improvement of such road, and to preserve such records, memoranda, and accounts until authorized by law to destroy or dispose of them."

§ 188. Capitalization for Acquisition of Working Capital

The working capital of a corporation consists of that part of its funds which may be used in the ordinary conduct

of its enterprise, to meet current obligations and pay ordinary expenses of operation.

In the capitalization of a new enterprise "there should be provided upon the commencement of operations a fair and reasonable amount of working capital. The operation of the company can be conducted with far greater efficiency, more to the satisfaction of the public and with better results to the stockholders if it has at all times in its treasury a working capital sufficient and adequate to meet the requirements of the road. Experience has demonstrated this so many times that insistence upon it or elaborate demonstration of its truth is not required at this time."¹⁰

For an operating company to acquire working capital through the issue of securities is an unusual procedure; nevertheless, it is practiced and corporate reorganizations often are based upon this expedient. The acquisition of funds for this purpose through capitalization seems to be expressly permitted by the New York Public Service Commissions Law which allows the Commissions to authorize the issue of stocks or bonds "for the improvement or maintenance of service." (See § 209.)

¹⁰ Rochester, Corning, Elmira Traction Co., 1 P. S. C. Rep. (2nd D., N. Y.) 166 (176).

CHAPTER XVIII

INTERCORPORATE RELATIONSHIPS, INVESTMENTS, CONSOLIDATIONS, MERGERS, AND REORGANIZATIONS

§ 189. Intercorporate Relationships Defined

Increased capitalization is often resorted to, and many problems of corporate finance arise out of the necessity of financing the creation or maintenance of intercorporate relationships.

Intercorporate relationships exist where one corporation is controlled by another, or where two or more corporations are controlled by a common interest.

Control over the *corporation* must be distinguished from control over the *property* of the corporation. Control over the corporation is an incident of proprietorship and follows the ownership of capital stock; this includes, of course, control over the property of the corporation, but the latter may exist by virtue of a contractual relationship only and without stock ownership, viz., through lease, or any other agreement by which the temporary or even perpetual control over the property is given to another by the owning corporation.

The report forms of the Public Service Commissions of New York contain the following definitions:

"1. *Control* over a corporation means ability to determine, whether directly or indirectly, the action of that corporation. For the purposes of this report, the following are to be considered control:

- I. Right, *through title to securities* issued or assumed by the controlled corporation, to exercise the

major part of the voting power in such corporation.

- II. Right, *through express agreement* of some character or *through some source other than title to securities*, to name the *major part of the board of directors*, managers, or trustees of the controlled corporation.
- III. Right to *foreclose a first lien* upon all or a major part in value of the tangible property of the controlled corporation.
- IV. Right to *secure control through advances made for construction* of road or other plant and equipment of the controlled corporation.
- V. Right to control *only in a specific respect* or respects the action of the controlled corporation.

"2. *Direct control* is that which is exercised without the interposition of an intermediary.

"3. *Indirect control* is that which is exercised through an intermediary. Where A has direct control over B, and B has direct control over C, it will (with possible exceptions in cases III and V above) be proper to consider A as having indirect control over C. . . .

"4. *Sole control* is that which rests in *one* person, corporation or other association.

"5. *Joint control* is that which rests in two or more persons, corporations, or other associations (or in any combination of two or more of these) and was acquired by them *through the same act or transaction or through the same series* of acts or transactions.

"6. A *proprietary corporation* is one all of whose stock is owned by the controlling corporation (or corporations in case of joint control).

"7. Two corporations are *affiliated* when both are subject to the control of some third corporation, or are subsidiary to the same controlling interest or interests."

Securities of the controlled corporation, ownership of which will give the controlling corporation right "to exercise the major part of the voting power in such corporation," must necessarily consist of shares of stock which have unrestricted voting power. For instance, if the stock of the controlled corporation is divided into common stock with full voting rights and preferred stock with limited rights to be exercised only in connection with specific corporate acts, the latter is ineffective for the purposes of control against the common stock. Securities "assumed by the controlled corporation" can consist only of funded debt or other evidences of indebtedness, since capital stock of one corporation cannot be assumed by another. Ownership of bonds does not carry with it control over the corporation, but may carry with it contingent control over the property of the corporation, and it is this contingent control which is referred to in the third subdivision of the first definition above. There are many instances where a corporation controlling by stock ownership also owns the bonds of the controlled corporation. In these instances the bonds have been acquired either as protection against the contingency of other bondholders acquiring control or possession of the property (e.g., through receivership, etc.), or else in financing the enterprise the controlling corporation preferred to issue its own bonds to the public rather than those of the controlled corporation, proposing to hold the latter as collateral to its own bond issue.

§ 190. The Development of Intercompany Relationships

The power to purchase and hold stocks of other corporations is one of the general powers exercised by practically all corporations. These powers must be considered, however, in the light of statutes restricting combinations, consolidations, and mergers. The provisions of the New York Public Service Commissions Law have already been quoted.

Intercompany relationships have in many cases become

very complex. The Interstate Commerce Commission on June 30, 1915, reported that of \$21,000,000,000 representing the total railroad capital outstanding and included in its compilations, \$4,800,000,000, or 23 per cent of the whole, was held by railroad companies themselves. Of these holdings about 40 per cent represented bonds and 60 per cent stock of the companies.

The great extent in which intercorporate relationships exist has been due either to the attempt to circumvent restrictive and special laws or to financial expediency. Unquestionably, too often they have been incidents of improper financing operations; since these have been the instances about which the public has heard most, recent legislation in the public utility and other fields has sought to eliminate or curb intercorporate relationships, direct or indirect, even to the extent of prohibiting directors of certain classes of corporations from becoming directors in certain other classes of corporations. The fact of the matter is that a great number of the interlocking relationships which now exist have been brought about by economic necessity which had to override the barriers of foolish legislation. The Railroad Securities Commission states:¹

"Some states have laws compelling railroads within their borders to be organized under the laws of the states in which they are located and forbidding foreign corporations, so called, from constructing, owning and operating lines thus located. The effects of this and other similar statutes have been largely avoided by a system of intercorporate holdings, under which a corporation organized in one state which owns the stock or the major part of the stock of a road in another state can secure the capital necessary for construction or betterment without subjecting itself to the restrictive laws of the state where the money is actually spent. . . .

"When the Chicago, Milwaukee and St. Paul railroad

¹ Pages 21 and 22 of report.

wished to build its Puget Sound extension it had to pass through several states whose laws forbid corporations chartered under laws of other states to build roads within their borders except as a connection or prolongation of a road actually built to the state line. In order to conform to these restrictions the St. Paul road would have had to build its line slowly, step by step, instead of doing work in several states at once and putting the road through as promptly as possible. To avoid this difficulty it had to organize a separate company to build the road in each state which had such a law. This in itself was not a serious evil; it simply involved additional expense to have separate corporations do things piecemeal which might have been done as a unit without such intermediaries. But it tended to render state control less effective, instead of more so. The system thus forced upon the St. Paul road would give every opportunity for deception to a road which might want to deceive."

Upon the same point, in describing the relationship between the Delaware and Hudson Co. and two of its subsidiaries, the Quebec, Montreal and Southern Company, and the Napierville Junction Railway Company, the New York Public Service Commission said:³

"The construction of these Canadian roads has been at the instance and under the full control of the applicant. They lie in a foreign country and the nominal ownership must be in a separate corporation or corporations. All of the stock of both companies is owned by the applicant. The roads constitute valuable extensions of the applicant's line. They will enable it to reach Montreal, when in full operation, and many other important points. They are well calculated to serve as traffic feeders to the system. It is important to the applicant in several ways that the bonds or temporary debt certificates of these extension lines shall be in its possession. They and the stock constitute full ownership in all but the

³ Matter of Delaware and Hudson Co., 1 P. S. C. Rep. (2nd D., N. Y.) 243 (274-275).

title or name. Parenthetically, it may be observed that, under restrictive laws of the State of New York, extensions of existing railway lines are necessarily accomplished in substantially the same way. A new company must be formed of which the parent company takes all the stock. Construction funds, in addition to the amount represented by the stock, must be provided, and in return bonds or debt certificates of the subordinate new company are taken. The simpler way, of course, would be to permit a railway to extend its line, upon approval of the Commission, and raise funds for the issuance of stock or bonds under an existing or new mortgage. The duplication or double issuance of capital would be thereby avoided and the necessity of keeping account for statistical purposes of capital issued because of intercorporate relations would to that extent disappear."

§ 191. Possible Dangers in Intercorporate Holdings

It cannot be gainsaid that the financing incident to the creation and maintenance of these intercorporate holdings has been and will be used as a vehicle of fraud and improper financial practices unless wisely regulated. In many instances where the expedient has been necessitated by the presence of laws placing undue limitations upon the development of an economically sound enterprise, the financing has been carried out in good faith so that no harmful results have accrued therefrom.

For instance, suppose A is formed as a subsidiary corporation of B, with a total capital stock of \$500,000 par value and bonds to the same amount. A markets its own bonds (probably carrying the guaranty of B as to principal and interest or either of them) and sells its entire issue of capital stock to B, the latter issuing its own stock (or, following the more usual practice, its collateral trust bonds) sufficient in amount to raise the sum required. The assets back of the increased capitalization of B consist of the capital stock of A,

and the assets back of the capital stock of A consist of the proceeds of its stock and bond issues and the other forms of capital into which those proceeds have been converted. The total sum invested by A is \$1,000,000, against which there are outstanding its own securities to that amount plus the \$500,000 of securities issued by B (supposing the latter to have been sold at par). It would appear as if there existed \$500,000 of "watered" stock. Such is not the fact, however, since the entire capital stock issue of A remains inactive so long as the corresponding issue of B remains outstanding, so that the total par value of securities in the hands of the public is only \$1,000,000. This last amount could be increased only as B should sell some part of its holdings, in which case the proceeds of the sale would add to the total assets back of the combined capitalization of A and B, and if the latter had issued collateral trust bonds instead of capital stock, it would not be able to sell any part of A's stock held by it. This is a very simple illustration describing a situation which has been kept wholly free from improper practices.

It would be a far different situation, however, if B had purchased A's stock at an unwarranted value, or else, having acquired the stock at a fair price, placed an undue valuation thereupon and based the issue of its own securities not upon the cost but upon the value placed upon the stock acquired and "written-up" on the books. In the former case it might be that the stockholders of A proposing to sell out to B were also stockholders in the purchasing corporation, and the sale of stock was merely a device for putting unearned sums in their pockets. Or, again, it might be that the officers of B had acted in utmost good faith but had been forced to pay an excessive price in order to shut off competition. Irrespective of the purpose and motive, however, the transaction results in the issue of securities of B to an amount in excess of the value of the assets owned or controlled. Even this last fact, however, may not be as bad as it looks; it may be that A's

properties bear such a relation to those of B that the enterprise could be made highly successful and values substantially increased if combined under one management, while the independent operations of each company would prove unsuccessful, if not wholly destructive of values.

The issuance by the controlling corporation of bonds to cover its stock holdings in a controlled corporation is open to the objection that it changes the contingent charges of capital stock into the fixed charges of a bond issue. It is hardly fair, however, to condemn the practice because of this contingency, described as follows in the report of the Railroad Securities Commission:

"A railroad company buying the stock of another company almost always issues collateral trust or other bonds to pay for it; in other words, it puts the stock into its own treasury and sells the bonds to the public. As long as the road is prosperous this change does little harm. In fact, it may appear to do good. When the company has been able to buy a 5 per cent stock by the issue of its own $4\frac{1}{2}$ per cent bonds, there is an apparent profit of one-half per cent annually on the transaction to the company and an apparent reduction in the total charges which it must meet. But with any diminution in traffic, the bad effect of the change is at once obvious. The interest on the bonds remains a fixed charge against the company. The effect of a loss of dividends would have been felt chiefly by the individual stockholders; a default, or even a threatened default, of interest, has an effect on the credit and confidence of the country as a whole and may precipitate a financial crisis."

Upon the enactment of the Public Service Commissions Law, the New York Central through the Mohawk Valley Company, a non-operating (holding) company, controlled a number of electric railroad, electric light, and gas companies. It was claimed that the provisions of the new law, while not requiring the Mohawk Valley Company to divest itself of its

stock holdings, would interfere seriously with the future financing of the properties and their legitimate development. The entire capital stock of the Mohawk Valley Company was then held by the New York Central and an unincorporated association called the Central Railway Syndicate; the former owning 60 per cent and the latter 40 per cent of the stock. A reorganization plan was worked out and placed before the Commission.³ It was proposed to reduce the capital stock of the Mohawk Valley Company by a pro-rata distribution to the stockholders of certain assets consisting of the shares of some ten different electric railroads. After the distribution and the attending reduction of stock of the Mohawk Valley Company, it was planned that the Rochester and Eastern Rapid Railway, one of the controlled companies, should increase its capital stock from \$1,500,000 to \$15,290,200, applying the total amount of the increase to the purchase of the stocks of four other controlled roads. This was to be a step preliminary to a consolidation of several of the companies in which the Rochester and Eastern Rapid Railway Company would itself participate. The Commission in its opinion goes very fully into the possible results of the increased capitalization and the acquisition of the stocks of the other companies for the purposes of control:

"There is nothing in the present condition of this company (the Rochester and Eastern Rapid Railway), if it is to be considered by itself, which demands for the purposes of its successful operation as a railroad that its capital stock be increased. For certain reasons it has been selected, however, as a company which shall become the owner and holder of certain other railroad stocks which must be placed somewhere under the proposed scheme relative to the holdings of the Mohawk Valley Company. . . . We should first inquire how public interest may be affected by the proposed large increase in the capital stock of the Rochester and Eastern Rapid Rail-

³ Matter of N. Y. C. and H. R. R. R. and R. and E. R. Ry. Cos., 1 P. S. C. Rep. (2nd D., N. Y.) 294.

way Company. It now has a stock issue of \$1,500,000, which may be assumed to be an amount proper and adequate for the discharge of its corporate duties as an operating company. The increase is simply for the purpose of owning and holding the stocks of other companies. Such holding cannot in any inquiry as to rates charged by it constitute an element in the case. In the determination of such rates, so far as the amount of capital stock constitutes a factor demanding any consideration, only the capital stock which may be justly said to represent the property operated would be entitled to be regarded. Capital stock which is issued to purchase other stocks must be eliminated in such an inquiry. There may be serious objection to constituting an operating railroad company a holding company, but the fact that its stock issued for holding purposes may be considered in fixing the rates it may charge for service is not an objection. It may well be that as an original proposition we would not consent to such an addition to the activities of a railroad company, but the case here presented of relieving an existing situation, entered into when it did not have the disapprobation of the law, manifestly demands a different treatment. . . .

"Any evil to the public must, therefore, be sought in some other direction, and would consist in permitting the issue of a large amount of stock upon a possibly fictitious basis, and which ignorant or improvident persons might be induced to purchase at a price greatly in excess of its real value. This is a danger which this Commission has certainly endeavored to guard against in other cases, and which we must now consider. We believe we should not permit an issue of stock for the purchase of other stock . . . unless the stock purchased has value substantially equal as a whole to the par value of the stock issued. . . . We must frankly say that the means of ascertaining with exactness the values of these stocks either do not exist or are not in our possession. We have satisfied ourselves, however, from a consideration of the towns in which

the properties are situated, the character and prospects of the communities served, that these properties have a great and growing value. From a consideration of the physical extent and condition of the properties, including the equipment, the gross earnings during a period of years, the aggregate indebtedness and amount of fixed charges, the aggregate amount of the capital stock, the conclusion which is vigorously urged upon us by the applicant may be fairly reached that the value of these stocks is equal to the par value of the stock to be issued therefor."

The Commission was careful to state, however, that its conclusion was not to be taken as "an unqualified approval of the results to which it assents. The Commission finds itself confronted with a situation arising out of a change of law. That change of law compels a change of corporate relations. To some change it must assent in order to preserve properties under its supervision in a condition to meet the public requirements which they were created to serve."

§ 192. Capitalization for Purposes of Intercorporate Holdings

From the extended quotations given above, three ruling principles may be deduced:

First, where authority to permit or withhold permission for the purchase of stocks of other companies for the purposes of control is vested in the commission, the commission will be warranted in giving its consent where the actual consolidation of the companies to be related would not be contrary to public policy.

Second, the securities to be issued for the purpose of acquiring the stock of the other companies should bear a reasonably proportionate value to that of the stocks to be acquired.

Third, where the controlling corporation is also an operating company, the added capitalization shall be arranged so as not to place an undue burden upon its own income and to identify the classes of stocks or bonds used for the acquisition

of operating capital and those used for the acquisition of stocks and bonds of subsidiary companies.

§ 193. (1) Relationship Which Should Exist Between Projects of Affiliated Companies

The first proposition requires a similarity and intimacy of operations between the corporations to be related. In other words, there must be a reason for the unification of interests. Where the company to be controlled is one newly organized in the interest of the controlling corporation and for the purposes of constructing a plant or railroad which essentially represents an extension or enlargement of the older company's project, the reasons for the intercorporate relationship are obvious. But if both companies have been conducting operations independently of each other, then the reasons are not so easy of proof. If they are engaged in similar businesses, there should be physical relationship of the plants or some connection in the enterprises because of community of interests in the territories served, or there should be some such tangible evidence of a real intimacy between the operations of the two corporations to justify a unification of corporate control as well. It has always been considered as in line with public policy for a railroad corporation to control a connecting carrier. The extension of that principle renders intercorporate relationships proper where it applies to corporations whose properties might be operated as a substantial unit, the one representing virtually an extension of the other.

If the companies to be related are not engaged in similar operations, the one must have some necessary relation to the other. The acquisition by one company of stock in another company operating a disconnected property may be a legitimate investment of surplus funds, but it is not a proper purpose for additional capitalization. The New York Public Service Commission for the Second District thus authorized a steam railroad corporation to issue bonds for the acquisition

of stocks of another company then operating electrically but chartered as a steam railway, on the ground that the purpose in purchasing that line with a view of proposed extension and junction with a third road "for railroad operations in connection with its railroad system is a purpose fully recognized by the statute as a proper basis for railroad capitalization." It also approved the issue of bonds for advances to connecting carrier companies, which represented "valuable extensions of applicant's line." It refused to allow capitalization for acquisition of stock in a traction and a coal company, saying:

"The Commission must distinguish between what are merely investments in disconnected properties and what are acquisitions of property having some definite useful relation to the public service operations of the corporation." The latter were held to be "not proper subjects of capitalization under the provisions of the statute."⁴

§ 194. (2) Value of Stocks and Bonds Acquired to Support Those Issued

The second proposition has also found a place in the statutes of some states. The purchase of stock is the purchase of property and, where more specific provisions are not embodied in the statute, is subject to the statutory provisions governing the issue of securities for the purchase of property. It would be fully covered, for instance, by the general provisions of the Wisconsin law that "no public service corporation shall issue any stocks or certificates of stock except in consideration of money, or of labor or property, at its true money value, as found and determined by the Commission . . . actually received by it, equal to the face value thereof, nor any bonds, notes or other evidence of indebtedness except for money, or for labor or property estimated at its true money value, as found and determined by the Commission . . . actually received by it equal to not less than 75 per cent of face value."

⁴ *Matter of Delaware & Hudson Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 243 (276).

The Elmira, Corning and Waverly Railway Company applied to the New York Public Service Commission, Second District, for permission to issue bonds in exchange for the stocks of certain other electric railroad companies,⁵ its purpose being to acquire and operate a continuous line of street railroad. "The first material inquiry," said the Commission, "is, what is the fair value of the stock and bonds proposed to be acquired. . . . It requires no discussion to establish the fact and, indeed, it is admitted by the applicant, that authority to issue bonds for this purpose and to this amount should be denied unless the property to be acquired is of value equal to the par value of the bonds to be issued therefor. . . .

"Three separate hearings were had upon this application, . . . and at each of these hearings it was distinctly stated to the applicant that it must establish to the satisfaction of this Commission that the values of the properties proposed to be acquired by it must be substantially equal to the par value of the bonds which it seeks to issue in payment therefor. The applicant in no manner questioned the justice and propriety of this rule, and, in fact, acceded thereto. It in effect offered little direct oral evidence upon the present existing values of the properties of the Corning and Painted Post and the Waverly, Sayre and Athens companies. It did offer the evidence of one witness as to what in his opinion the value of these properties would be after the construction of the applicant's road and the union of the three roads into one continuous operating line under proper management. This evidence, or more accurately, opinion, taken by itself would apparently support the contention that the properties would, under good management, be worth the sum claimed. On the other hand, it refrained from giving any substantial evidence as to existing values, except such as could be deduced from sundry accounts.

"The Commission has to the extent of its power carefully investigated the present values of these properties. It has not

⁵ Matter of Elmira, Corning & Waverly Ry. Co., 1 P.S.C. Rep. (2d D., N. Y.) 328.

indulged and cannot properly indulge in conjectures as to values at some future time, under circumstances and conditions which are necessarily unknown to it. The Commission has attentively considered all of the evidence in the case, and is satisfied that the value of these stocks, for which the applicant desires to pay \$500,000, is not that sum, nor does it so nearly approach that sum as to justify the Commission in granting the application."

Perhaps this is the statement of too rigorous a rule. Of course, the Commission should refrain from indulging in speculation, but it need not wholly disregard the probabilities of enhanced values to result from the increased business or operating economies following the unification of operations, especially where considerations of public policy render the unification of control desirable. Commissions allow for probabilities when they authorize a new project; in the case of reorganizations, if they adhered closely to the rule that securities of the new company could not be exchanged for securities of the old company except upon the basis of values then existing, reorganization would be impossible, for what is the value of a bankrupt company's securities? Nevertheless, in the consideration of applications such as that of the Elmira, Corning and Waverly Railway Company, the Commission must pursue a rigorous policy because of the many opportunities for later abuse of its authorization. Where actual consolidation or merger does not result, the exercise of control over another company is subject to considerations of corporate policy, and corporate policy is a changeable factor within the sole control of the company's directors, while the Commission will be practically powerless to control it in the slightest degree if its direction is such as to defeat the probabilities which were urged upon the Commission and on the basis of which the authorization was made.

The decision of the same New York Commission in the Spuyten Duyvil and Port Morris Railroad Company case

illustrates one method of valuing stocks proposed to be acquired, as well as considerations of public policy which may become controlling. Headnote to the opinion is: "Approval of purchase by a railroad corporation of stock in another railroad corporation where obvious public advantage is shown."

The Spuyten Duyvil and Port Morris Railroad Company owned a short line of railroad, 5.31 miles, leased by the New York Central and used as a part of its main line, thus constituting "a most vital part of the great New York Central system, holding the key of its entry into the city of New York." The rental paid was \$79,120 and the lessee had expended considerable sums for improvements on the leased road. The New York Central applied for permission to acquire the entire capital stock of \$989,000 par value, paying therefor at the rate of \$230 a share, explained to be based on the rental capitalized at 3½ per cent. The Commission said:

"While this amount, \$2,274,700, is thus over twice what the original investment was, yet in view of the fact that the road represents to the New York Central an investment of \$3,191,074, which at the end of the lease will pass to the Spuyten Duyvil and Port Morris Railroad, the arrangement is very advantageous to the railroad. . . .

"Upon consideration of the above facts it would seem as though there could be no possible doubt or hesitation. However one may question the wisdom of the New York Central Company in 1871, when it entered into the contract of the Spuyten Duyvil and Port Morris Railroad Company, or question the policy of the New York Central in having made such extensive improvements upon a right of way it did not own, and investing such enormous sums upon terminals which it can reach only over such right of way, yet the present management of the New York Central is certainly to be commended for remedying such a condition of affairs and making the proposed advantageous contract." ⁶

⁶ Matter of N. Y. C. & H. R. R. Co., 1 P. S. C. Rep. (2nd D. N. Y.) 466 (467, 469).

§ 195. (3) Company Acquiring Holdings Not to Burden Its Own Operations

The third principle is that the intercorporate relationship shall not impose upon the holding company an undue burden upon its own income or earnings, or by the changing of contingent charges to fixed charges impose an undue burden upon its own rate-payers. One danger in changing contingent charges into fixed ones has already been described in the quotation from the report of the Railroad Securities Commission (see § 191). The other danger is that the holding company may seek revenue from its own rate-payers to apply to payments of interest upon bonds or of dividends upon stock issued for the securities of controlled corporations, which have not been able themselves to earn an amount sufficient for this purpose.

"It must be that the annual charge upon the gross annual income of the railroad properties of the applicant for a purpose unconnected with those properties and arising wholly from another line of business which it is authorized to carry on, tends to limit the amount annually available for the proper management and betterment of those properties; that a lien upon such railroad properties for an indebtedness not connected with them directly limits by the amount of such indebtedness the credit of the applicant in borrowing upon the security afforded by such properties sums which may be necessary for their betterment and improvement and which would be properly chargeable to capital."[†]

§ 196. Holding Companies

The preceding discussion has referred mainly to intercorporate relationships where the controlling corporation is an operating company, with a very slight reference to the situation of holding companies. The problems involved are almost

[†] Concurring opinion of Mr. Stevens in *Matter of Delaware & Hudson Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 392 (442).

identical in both situations except that, since holding companies are not themselves directly engaged in active operations, considerations as to the effect upon the income of the holding company are not of as great importance. There are many instances, of course, where an operating corporation also performs the functions of a holding company, e.g., the Rochester and Eastern Rapid Railway Company, described in § 191.

A holding company is one organized and existing for the special purpose of owning the shares of stock of, and by virtue thereof controlling, another corporation. It may be an operating company itself or solely a holding company.

Holding companies are organized either to circumvent laws against consolidations, mergers, etc., or to unify under a common management the operations of companies whose consolidation is for one reason or another inexpedient. A notable incident of the former class was the attempted organization of the Northern Securities Company, incorporated in 1901 in New Jersey. It acquired control of both the Northern Pacific Railway Company and the Great Northern Railway Company, holding \$153,750,640 out of \$155,000,000 capital stock of the former and \$118,124,200 out of \$124,109,200 of the latter. The consolidation of parallel or competing lines was prohibited by some of the states crossed by these railroads, and the device of the holding company was resorted to to accomplish indirectly that which the law would not permit to be accomplished directly. In 1904 the Supreme Court of the United States ruled that the control vested in the Northern Securities Company was illegal and directed the holdings to be distributed among those whom the court conceived to be the proper owners.

There has been much discussion concerning the relative merits and demerits of holding companies, a great deal of which is not pertinent to this study. So far as these companies serve as a device for combination, the problems to

which they give rise are identical with those common to all combinations.

The capital of a holding company consists of the shares of stock of controlled corporations held by it; the value of its equity in the properties of those controlled corporations comprises its fixed assets. Its income consists of the dividends and interest collected upon the shares of stock and the bonds held.

In the financing of the holding company, it either uses its own securities in the direct exchange of shares to be acquired, or else markets its own securities and uses the proceeds for their purchase. If the purchase price has borne a proper relation to the actual value of the corporate assets and there has been no "writing-up" of values to support an inflated issue of securities, the financing is economically sound. Very often, however, it is attempted to place a greater value than the purchase price upon the shares acquired in order to capitalize the supposed advantages of unifying the operations of a number of companies and introducing economies in operation or effecting the betterment of methods and processes. It would be much better to allow the financial effect of these advantages which accrue to the benefit of the holding company to be expressed in the earnings and dividends, rather than in the capitalization of the holding company.

"The returns to which a holding company is entitled must depend upon the returns to which the stock held is properly entitled, and any interest of the public is confined to the stock which stands as the representative of operating property. The public pays a price for a given service. That price may, perhaps, be greater or less, according to the sum invested in the property used in rendering the service, and the amount of stock of the operating company may, perhaps, be considered in arriving at that sum. But further than this we cannot go. Thus the amount of stock which the Rochester and Eastern Rapid Railway Company chooses to issue to the owners of

stock in, say, the Oneida Railway Company, can never be properly considered in determining to what return the stock of the latter company is entitled. If the truth were otherwise, the returns upon the stock of a given company would be made to depend upon the prices which individuals might choose to pay for it, which is clearly inadmissible.”⁸

The mere fact that a person is a stockholder in a public service corporation does not bring him within the general jurisdiction of a public service commission. A holding company is merely a stockholder in other corporations and its status is not in any respect different from that of any other individual stockholder; accordingly, that relationship is not enough to bring a holding company within the jurisdiction of a public service commission unless the statute clearly extends the jurisdiction to cover holding companies.

§ 197. Stocks, Bonds, or Physical Properties Acquired as Investments

It may be stated as a general rule that stock holdings of public service corporations representing the shares of another corporation, these last not being sufficient in proportionate number to carry control and not clearly acquired as an incident of a definite program of securing control, will be deemed to have been acquired and to be held as and for the purposes of investment. The same is true where, even if sufficient to carry control, the property or operations of the controlled corporation bear no general relation to the controlling company's public service enterprise. Holdings of bonds and other certificates of indebtedness will be classified according to whether or not there is attending control of the property or operations, the necessity of the control being judged by the rule above expressed.

Stocks and bonds held as and for purposes of investment

⁸ Matter of N. Y. C. & H. R. R. Co. and R. & E. R. Ry. Co.'s, 1 F. S. C. Rep. (2nd D., N. Y.) 294 (316).

by a public service corporation are not generally proper subjects of capitalization. Their acquisition should be financed out of surplus profits rather than out of funds derived from capitalization. While these corporations are empowered to acquire and hold stocks and bonds of other corporations, they must exercise that power as incidental to their main business of public service, and they do not become privileged to enter the investment field to any large extent. If such a company has large surplus funds which cannot be advantageously invested in its own business, it will serve the ends of public policy better by a distribution among stockholders than by investment in stocks and bonds of other corporations.

Subject to almost the same considerations as the foregoing are investments in so-called "outside properties," representing properties not directly used or needed in the operation of the public service enterprise. Very often the classification of properties owned between those necessary for the enterprise and those representing investments is a difficult one to make. In the course of the valuation of railroad properties now under way, great difficulty is being encountered in distinguishing between "carrier" and "non-carrier" properties, and no one has succeeded in framing a rule which has proved satisfactory or even applicable in all cases. So far as problems of capitalization are concerned, properties, in themselves unnecessary for the purposes of the public service but which must be purchased as a part of other properties essential to that service, become proper subjects of capitalization. Having acquired them out of the proceeds of stock and bond issues, the corporations will not thereafter be required to treat them as investments made out of surplus profits. It would be reasonable and very proper, however, that it should be required to account for the proceeds of any subsequent sales of such properties by investing the proceeds in extension, addition, or improvement of its fixed capital; otherwise the corporation will be able to apply proceeds of capitalization to purposes not contemplated

by the commission authorizing the issue of stocks and bonds.

"A public service corporation should not engage permanently in any other business than that for which it is incorporated; but where it is desired to equip temporarily property which is held for future public service, and such property can be shown to be ultimately desirable and temporarily not a burden upon such public service, this Commission should not withhold its approval.

"In such case a careful division of accounts should be made between the public business and what might be called the private business of the corporation; and the latter should not be allowed to become a drain upon the public service; nor by increasing relatively to the public business to become a permanent business of the corporation."⁹

Such was the principle enunciated by the New York Public Service Commission, Second District, in the application of the Watertown Light and Power Company, an electrical corporation, for authority to issue bonds to discharge certain obligations incurred in additions and betterments to its plant, including therein additions and improvements to properties other than those devoted to electrical operations, to wit, a pulp mill and certain real estate.¹⁰ The situation confronting the Commission was a perplexing one.

"Here is a light and power company owning a pulp mill and investing large sums of money in developing water power, which, whether or not it may ultimately be required for public service, is for the present, at least, and for an indefinite time in the future, to be used in the manufacture of pulp. Here is the same light and power company owning real estate upon which it has erected a large building, for which it has no use at present in its public service capacity and which it lets to numerous tenants.

⁹ *Matter of Watertown Light and Power Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 146 (162-163).

¹⁰ *Id.*, pages 159, 162.

"Is this Commission authorized in approving the issue of securities for such investments? The Watertown Light and Power Company, as a public service corporation, evidently cannot borrow money to make improvements upon its pulp mill without coming to this Commission for approval, and it is certainly not public policy to allow such property to deteriorate or be undeveloped; yet the purpose has really nothing to do with public service—except that the water power so developed may at some future date be needed for such service. It is the same as to the other building mentioned. The officers of the Watertown Light and Power Company state that at some future time they expect to make public use of the building which they have erected, although it is not claimed that it is in any way necessary to their business at present. Ought this real estate to lie idle and unremunerative because it is not at present directly related to public service? Ought a public service corporation to be compelled to dispose of property which may become necessary to its business at some future time because it cannot at once make use of it?

"It would seem that the only solution of this question is to construe the act so as to allow a reasonable and intelligent business judgment to prevail in such matters; deciding each individual case upon its merits; for what might be perfectly safe and sound business judgment in developing a particular piece of property in Watertown might be very poor business judgment in developing a similar piece of property in another place."

§ 198. Consolidations and Mergers

Consolidation occurs when two or more corporations are combined together to form a new corporation. The identity of the new corporation so formed is separate and distinct from that of each of the constituent companies, even though the name of the new company corresponds to that of one of the consolidated companies.

Merger occurs when one corporation merges into itself another corporation. The corporate existence of the merging corporation is not affected, while that of the merged company is absolutely terminated by the merger. The name of the merging company is not changed by the merger.

§ 199. (1) Capitalization of Consolidating Companies Important

It is a general provision of corporation laws or public utility laws, or of both, that the capital stock of a consolidated corporation must not exceed the aggregate of the capital stocks of the consolidating corporations. The prohibition by its terms relates only to capital stock and does not expressly extend to funded debt, but if the interpretation of the Public Service Commission for the Second District of New York in one of its early decisions is correct, and it does appear well-founded, this prohibition should be understood to relate to the entire capitalization. The New York statute reads as follows:

“Nor shall the capital stock of a corporation formed by the merger or consolidation of two or more other corporations, exceed the sum of the capital stock of the corporations so consolidated, at the par value thereof, or such sum and any additional sum actually paid in cash.”

In construing the above section of the statute, the Commission held that its policy should be to require the total capitalization of the consolidated or new company, whether stock or bonds, issued in exchange for the securities of the old companies, to be not in excess of the total capitalization of the consolidated companies. The Commission said:

“The purpose behind the statute, however, is perfectly clear. The provision of law in question is designed to prevent those large increases of capital issues which have so often accompanied the consolidation of public service corporations in the past, and which have imposed heavy burdens on munici-

palities in the way of inadequate service and excessive prices through the endeavor by the overcapitalized company to earn interest and dividends on the excessive issue of securities. If this beneficent purpose of the statute can be evaded . . . by leaving the aggregate capital stock unchanged, but imposing the same burden upon the community through a greatly increased issue of bonds, the statute totally fails to accomplish the intended purpose.”¹¹

The requirement that the total capitalization of the new corporation shall not exceed the aggregate of the stock and the bond issues of the consolidated companies does not, of course, set any limitation upon the action of the corporation to increase its capitalization. The new corporation immediately after the consolidation is consummated may increase its capitalization, or the increase may even be made as an incident of the consolidation proceedings. The purpose of the increase must not be related to the consolidation itself, however, but rather to the extensions or improvements to be added to the consolidated properties.

Neither does the prohibition contemplate that the stock of each of the constituent companies shall be exchanged on equal terms. The stock of one may be exchanged at par, while that of the other will be at below or above par; any ratio of exchange may be adopted to produce a fair and equitable readjustment of interest and control in the new corporation by the stockholders of the old corporations.

Nor does the prohibition affect in any way the capitalization of a merging corporation. A merging corporation is required to be in possession, before the merger, of every share of the capital stock of the company to be merged. In the acquisition of that stock it may have issued its own securities or utilized its surplus assets, but when it has acquired all of the capital stock the fact of merger does not present any occasion for disturbing the capitalization of the merging company.

¹¹ *Matter of Lockport Light, Heat and Power Co.*, 1 P. S. C. Rep. (and D., N. Y.) 12 (20).

Where public utility laws are in force, all consolidations and mergers are subject to the approval of the commission. Special statutes control in many states, and the anti-trust laws of states and of the federal government against combinations obtain with full force.

In the Lockport case mentioned above, the attempt was made to avoid the prohibition of the statute; each corporation included in the unifying scheme was to sell its property and franchises to a newly organized corporation. While admitting that technically this was neither a consolidation nor a merger, the Commission characterized the project as one "effecting consolidation by the use of a newly organized purchasing company, without technical merger or consolidation of the existing companies," and for the purpose of giving effect to the statute treated the application before it as one relating to consolidation.

§ 200. (2) When Values of Consolidating Properties Need to Be Considered

The underlying purpose of the statute limiting the capitalization of the consolidating corporation is to protect against overcapitalization. But this overcapitalization may be accomplished not only by the issue of securities in excess of the capitalization of the consolidated companies, but also by carrying into the consolidating company the overcapitalization already existing in one of the consolidated companies. In the attempt to have the consolidated company kept free of overcapitalization, it is a reasonable and proper policy for the regulating commission to inquire into the capitalization of the consolidating companies. The Commission "will consider the relation of the value of the constituent properties to the proposed capitalization of the new or consolidated company (including when necessary in such valuation an allowance for intangible matters, and also allowing in the comparison for discount on the sale of bonds), in order that the Commission

may act with understanding, and, if warranted thereby, disapprove a consolidation plan providing large capitalization and relatively small property value.”¹²

“If it does not appear that the combining of the stock, bonds, and outstanding indebtedness of the three companies would exceed the fair valuation of the combined plants, or that the value of any one of such plants is greatly less than its capitalization and floating debt, so that the consolidation would diminish the resources for the service and operation in fields now occupied by others, or that the public interest would be otherwise adversely affected, these companies should under the facts above stated be permitted to consolidate. . . .

“From an examination of the properties by our engineers and an examination of the books and records of the companies by our special examiner, we are satisfied that the value of the Newburgh and Poughkeepsie properties for the purposes of this case is in excess of the stock and bond capital and the excess of bills and accounts payable over bills and accounts receivable. Such examinations indicate, however, that certain changes in bookkeeping are important and necessary in order that the facts involved may be more clearly shown and true surplus be stated. . . . We think the financial and income statements fairly warrant the consolidation, if the proper amounts are written off from the Fixed Capital accounts. . . . The necessity for a revision of accounts at this time is demonstrated by the fact that it would be practically impossible to require such revision after a consolidation.”¹³

§ 201. (3) Considerations of Public Policy

In the concurring opinion, Mr. Stevens thus summarized the elements of public interest to be inquired into: “In the case of the proposed consolidation, if the Commission can see

¹² Headnote to *Matter of Wayne County Gas Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 500.

¹³ *Matter of Poughkeepsie Light, Heat and Power Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 649 (649-657).

that such consolidation may have a tendency to impair the service or to produce unreasonable rates, or to impair the value of the securities offered by the corporation for sale to the public, then it is the duty of the Commission to place its negative upon the contemplated action. If it cannot see that any results of this character might ensue, or if they did ensue that it would be unable to deal with them properly and effectually, I am unable to perceive how it can justify itself in denying the corporations the right to exercise the privilege conferred upon them by law. There certainly must be a reason for exercising the negative of the Commission, and I cannot believe that any reason is adequate unless it is something which makes possible remediless evil against public interest, or makes difficult or impossible the proper and effective application of public control.”¹⁴

One way in which consolidation may make difficult the application of public control lies in the massing of accounts covering possibly several municipalities wherein different rates are charged or different conditions of rendering service prevail, so that upon an inquiry into rates the Commission might be confronted with a situation where the costs of service and the value of separate plants in the several municipalities could not be determined. To safeguard against this the Commission has, in a number of cases, required the consolidated company to keep its accounts separately for the territories served by the constituent companies. There is no reason why such requirements should be made only of consolidated companies; both the public and corporate interests are better served where costs of service, so far as they may be allocated, applicable to separated communities are kept by themselves. Such, in fact, is the usual practice; the problem is not so much the introduction of a new method as the perfection of the existing methods through better records and more correct bases of allocating “overhead” and general expenses.

¹⁴ *Matter of Poughkeepsie Light, Heat and Power Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 644 (661).

§ 202. Corporate Reorganizations

The control of the issues of stocks and bonds in reorganization proceedings is one of the most important aspects of regulation. The financing of reorganizations has heretofore been a very loose and elastic thing; since it almost always resulted from the compromise of conflicting interests, it seldom was made responsive to any fixed principles. The necessity for reorganization has usually been the result of bondholders' demands and inability of the company to meet the current fixed charges, or else the maturity of principal. In such case the inability denotes lack of credit because of earnings insufficient to care properly for the fixed charges and to leave an adequately protective surplus besides, and the one purpose which has been common to most reorganizations has been that of cutting down the amount of fixed charges to be required by the new capitalization. This has required the new bond issue to be smaller than the old, but to satisfy the bondholders for the destruction of their claim, they were given shares of stock instead, most often the par value of the shares offered exceeding the par value of the bonds cancelled. The general result has been that a company going through reorganization came up at the termination of the process with a total capitalization very much greater than the old capitalization. In many cases the process has been repeated over and over again, and each instance has been the occasion for increased capitalization.

The term "reorganization" may be used in several different meanings. It may refer to a reorganization of the finances by agreement among the stockholders, bondholders, and other claimants. Such a reorganization would come before a regulating commission largely as an application to undertake funding and refunding operations, to issue stocks and bonds for the purpose of acquiring new capital, or for the maintenance or improvement of service, etc.

Reorganization may also refer to instances where through intercorporate relationships the financial affairs of one of the

companies are recast and its properties and operations modified. There is no corporate reorganization here, and so far as there may be reorganization of finances the incidents thereof will be identical with those described in the above paragraph. Sometimes the changing of company directors and officers is spoken of as a corporate reorganization, while it represents merely reorganization of operations and management.

Corporate reorganization is the usual result of bankruptcy and foreclosure. A company defaulting on its obligations has its properties placed in a receivership, and ultimately sold pursuant to an order of the court. The statute then empowers the purchaser at such sale to associate with others into a new corporation to succeed to all the properties, franchises, and rights which were included in the sale. The purchaser very frequently represents bondholders of the bankrupt company, who by taking over the property for operation hope eventually to save themselves from loss. The new company is then called upon to provide for the payment of the purchase price, to be carried out in large measure by the exchange of securities, and to raise new capital to improve the properties, continue the operations, and in general to get a new start in the business. The plan will have been agreed upon in advance, but where there are many classes of bondholders, secured-note holders, etc., to be brought within the agreement, the financing problem becomes quite complicated.

The New York statute as at first enacted was held by the courts to be ineffectual in conferring upon the commissions jurisdiction over these reorganization proceedings, and the defect was made good by an amendment which reads: "Reorganization . . . shall be subject to the supervision and control of the proper commission and no such reorganization shall be had without the authorization of such commission.

"Upon all such reorganizations the amount of capitalization, including therein all stocks and bonds and other evidence

of indebtedness, shall be such as is authorized by the commission which, in making its determination, shall not exceed the fair value of the property involved, taking into consideration its original cost of construction, duplication cost, present condition, earning power at reasonable rates and all other relevant matters and any additional sum or sums as shall be actually paid in cash, provided, however, that the commission may make due allowance for discount of bonds. Any reorganization agreement before it becomes effective shall be amended so that the amount of capitalization shall conform to the amount authorized by the commission."

Both the First and Second District Commissions in exercising authority over the capitalization of reorganized companies had held, before the enactment of this amendment, that the stocks and bonds to be issued should bear a distinct relation to the value of the properties to be acquired. So far as the authority of the statute was concerned, the purpose of issue was assumed to be "the acquisition of property." The Second District Commission accordingly held that the reorganized company could be authorized to "issue stock and bonds for the acquisition of the property of the corporation which was sold upon judicial sale; that such stock and bonds may be authorized to the amount of the fair value of the property sold upon such judicial sale, and that such property must be either tangibles or such intangibles as constitute a right to demand and receive or otherwise enjoy the possession of tangible property."¹⁵

The Court of Appeals in overruling the decision of the First District Commission in the Third Avenue Railway Company case held that the capitalization of a corporation formed on the reorganization of a foreclosed railroad did not depend upon the value of the property, and that there was no rule of law or statute requiring the capitalization to be scaled down to the actual value of the property. In this respect the status

¹⁵ Matter of Genesee Light & Power Co., 2 P. S. C. Rep. (2nd D., N. Y.) 413 (482).

of the reorganized company was likened to the situation of a consolidated company whose capital stock was required by law not to exceed the aggregate capital stock of the consolidating companies, there being no reference to the value of the properties; thus indicating a policy of the law, in some cases at least, to ignore the value of the properties acquired on a test of the amount of securities to be issued. The subsequent amendment of the statute, however, specifically provided that the capitalization of the new company should not exceed "the fair value of the property involved, taking into consideration its original cost of construction"

The value of the properties of a bankrupt railroad, gas, or power company would be difficult of determination. Take a property very expensively constructed and for a volume of business far in excess of that which has yet been developed. The capitalization has been conservative and does not exceed either the cost to build or the present cost to reproduce, and if the expected volume of business had developed there would have been no difficulty in meeting all obligations. The company becomes financially embarrassed, defaults on its payments, and the plant is foreclosed. To insist that the securities of the new company shall not exceed the value of the foreclosed property, judging of that value either by cost to build or reproduce, since no other index is available, would not help in the slightest. The real considerations in reorganization cases will often be very complex; the mistakes of management, the reasons for inadequate business, the condition of plant, the prospects for favorable development, etc., all will need investigation and may present very forceful considerations. It is best, in view of these facts, that special powers should be conferred upon commissions in dealing with reorganization cases. Perhaps in no other class of cases dealing purely with capitalization may the commission exercise as great a constructive influence.

CHAPTER XIX

CAPITALIZATION FOR SUNDRY PURPOSES

§ 203. Reimbursement of Moneys Expended from Income

An operating corporation will constantly make minor additions to its fixed capital, the expenditures for which, paid out of current income, may ultimately amount to a considerable sum; or it may undertake an extension or addition to its plant and likewise meet the cost out of current income or accumulated surplus, rather than from the immediate issue of stocks or bonds. In either case the corporation expects eventually to capitalize these expenditures, that is to say, to issue stocks or bonds or both for such an aggregate amount as it would have been authorized to issue in the first instance if it had proposed to pay for these projects out of the proceeds of capitalization. However, the question of intent is not at all controlling, and the expenditures may be capitalized even though there had been no original intent to do so. The expenditures may even have been charged to operating expenses because it was not supposed that they would ever be capitalized. Of course, where this last situation obtains, the accounts must be restated before or concurrently with the capitalization of the expenditures.

Expenditures which were actually made and were such that they could properly have been or were charged to capital accounts, may be capitalized under the public service commission laws of the several states permitting capitalization "for the reimbursement of moneys actually expended from income . . . or from any other moneys in the treasury of the corporation not secured by or obtained from the issue of stocks, bonds, notes or other evidence of indebtedness of

such corporation, for any of the aforesaid purposes except maintenance of service and except replacement.”¹

§ 204. (1) Capitalization for This Purpose a Limited Right

These appropriations of income represent contributions of stockholders just as much as if they had made direct payments to the corporations. The stockholders could have withdrawn the earnings in the first instance if they had chosen to make direct contributions or to secure advances on stock and bond issues for the cost of the new construction, and they may therefore do so at any later time unless there is a specific prohibition or time limitation of the statute. The New York statute, for instance, limits capitalization for reimbursement of income to moneys “actually spent from income within five years next prior to the filing of an application.” The continued existence of the right without some definite limitation would tend to defeat the real purpose of the law, which is that of controlling capitalization by regulating the expenditures of the proceeds. That purpose could not be carried out if the corporations were permitted to go ahead and make expenditures upon projects which will come before the Commission for examination only after completion, and after liabilities have been incurred and contractual obligations assumed which will seriously hamper the consideration of the merits or necessity of the project. On the other hand, to restrict the right of issuing stocks and bonds to meet future expenditures alone will do more harm than good; some measure of freedom has to be extended to corporations to make needed improvements and replacements without the delay of formal applications and hearings. The authority must not be abused, however, and important projects which will ordinarily require long periods of deliberation and investigation, and involve relatively large sums, should not be undertaken under this clause.

¹ Quotation from New York statute.

The New York statute made provision for capitalization to reimburse income for all proper expenditures, without any limitation to a five-year period, provided application was made before January 1, 1912. This temporary authority was necessary to afford an opportunity to those corporations which had financed or were then financing additions and betterments out of income to carry out their plans while adjusting themselves to the new requirements. The statute reads:

"Nothing herein contained shall prohibit the Commission from giving its consent to the issue of bonds, notes or other evidence of indebtedness for the reimbursement of moneys heretofore actually expended from income for any of the aforesaid purposes (acquisition of property, construction, etc.), except maintenance of service and replacements, prior to five years next preceding the filing of an application therefor, if in the judgment of the Commission such consent should be granted; provided application for such consent shall be made prior to January first, nineteen hundred and twelve."²

§ 205. (2) Effect of Reimbursing Income by Stock Issue

If the expenditures for which income is to be reimbursed have been charged to capital account, they have added to surplus; if they have been charged to expenses, they must be transferred to capital account if reimbursement is to be made through capitalization, thereby adding to surplus. To reimburse the treasury of the corporation from the proceeds of capitalization is to reimburse the stockholders, since the proceeds go into the treasury and there become available for any purpose whatsoever, most usually being used for distribution as special dividends. An authorization to issue stocks or bonds to reimburse the treasury is necessarily a finding that a definite amount of the stockholders' present equity represents earnings of the enterprise retained by the corporation. Sup-

² The New York Public Service Commissions Law took effect July 1, 1907, for all classes of corporations except telephone and telegraph corporations, and as to the latter it took effect September 1, 1910.

pose that equity to be \$50 per share represented by expenditures in plant. The sole purpose of issuing stocks or bonds against this \$50 is to make this increased equity available to the stockholder in one way or another. The corporation may issue stock for the amount and present the stock certificate to the stockholder as a special dividend and thus make the equity available to him in a certificate of increased proprietorship which he may either hold or dispose of, just as he pleases. Or the corporation may issue the stock and offer it for sale; if it is all taken up by the stockholders to whom it is first offered, each one will contribute \$50 for every share of stock. If a special dividend of the full amount of the proceeds is then declared and paid, the stockholders will receive a dividend of \$50 for each share owned; the net result will be the same in every way as if a stock dividend had been declared. But if the proceeds are not divided among the stockholders, their equity will remain precisely as it was before the issue of the new stock. If the new stock is taken up by others than the existing stockholders, or if bonds are issued and the proceeds used for a special dividend, the stockholder will receive \$50 in cash and the value of his holdings will go back to what it was before the increased equity arising from the application of earnings to capital expenditures was made. In other words, that portion of the increased equity is made available to him in cash, while if the proceeds are not divided among the stockholders but used in the regular course of corporate business, his equity will remain undisturbed.

§ 206. (3) Analysis of Accounts to Determine Amount to Be Reimbursed

Accounting methods have not developed so far as to make possible the tracing of expenditures to definite sources of the funds used therein; consequently it is impossible to secure by mere examination of capital or cash accounts definite information that the expenditures were made out of income.

A conclusion as to the source of the funds with which the expenditures were paid is a general conclusion from a study of all the accounts and is arrived at by a process of elimination. The conclusion, therefore, will better reflect the process of elimination by which it was reached if it is stated in terms that the expenditures were not paid out of the proceeds of stocks, bonds, or other evidences of indebtedness, instead of saying that they were paid out of earnings. The New York Public Service Commissions Law properly reflects this difficulty of identifying the source of funds in the phrase "expended from income or from any other moneys not secured by or obtained from the issue of stocks, bonds, notes or other evidences of indebtedness of such corporation." Yet it may be that, while the moneys expended had not been secured from the issue of stocks, bonds, etc., income may not be reimbursed for the expenditures by the application of the proceeds of capitalization, for it may be that the expenditures represent the investment of special funds; for instance, a fund set aside for accrued depreciation which has been invested in plant rather than in securities or other properties, so that under these circumstances the fund is not permanently invested in the fixed capital but only temporarily so, pending the time when it will be used to purchase replacing property; in the meantime it may not, of course, be capitalized.

The statute quoted above expressly prohibits the Commission from giving its consent to the issue of stocks, bonds, etc., for the reimbursement of moneys expended from income for the maintenance of service and replacements. The Commission is placed under the responsibility of ascertaining definitely that expenditures for such purposes are not included in the total amount for which income shall be reimbursed, but even with the most careful scrutiny and investigation there will be cases where neither the company nor the Commission will be able to demonstrate conclusively that no

part of the moneys were expended for replacement. The statute will be satisfied if from all the facts it appears that the moneys were expended for proper purposes. Even in cases where the authorization relates to expenditures still to be made, it sometimes becomes difficult to determine that all of the capital to be acquired thereby will represent additions to, or betterments of, capital and not replacements in any part. Take the application of a railroad company for authority to issue stocks and bonds for the acquisition of large numbers of cars. How can it be determined that all of these cars will be additions and not replacements of capital? So far as the present records are concerned, there may be no evidence that any of them are to be acquired in replacement, but if there have been cars retired in previous years and new ones installed which were purchased out of the proceeds of stocks and bonds, should it be considered that those cars were in replacement of those retired, or should it be said that the cars about to be acquired will be in part replacement of those retired in past years? The facts become very difficult to obtain under these circumstances. Or again, if there is no indication that the new equipment will be in replacement, in whole or in part, suppose there are large numbers of cars which will be retired in succeeding years; then the new equipment acquired gives the company a surplusage of capacity so that when the old cars are retired no others will be purchased to replace them. Later on, it may appear clearly that some of the new equipment was actually used for replacement. The possibility of such a situation developing in the future may be a proper consideration but it could not be sufficient reason for withholding authority for the acquisition of the new equipment, especially in view of the fact that it will be impossible to foretell whether such equipment will give a surplusage of capacity or not, since that will depend wholly upon the fluctuations in volume of traffic. If guarding against the application of proceeds of capitalization to re-

placements of capital is such a difficult problem in relation to expenditures still to be made, it becomes more difficult when arising in connection with expenditures which have been made some years before.

One aspect of the prohibition against reimbursing income for expenditures on replacements or for maintenance of service is its application to depreciation. This matter is very often overlooked, or else it is imperfectly understood. Suppose it is sought to reimburse income for the cost of equipment purchased three years ago at \$100,000. In the operations for three years a part of its service-life has expired, and the earnings of the company have returned or should have returned to it a proportionate part of the cost. If accounting has been adequate, this proportion of cost will have been set aside as a depreciation reserve out of charges against the current operating expenses, which charges become part of the cost of maintenance, and a reserve for replacement, so that income may not be later reimbursed therefor. This will hold true, undoubtedly, even if the accounting has not taken care of the depreciation.

The terms of the New York State law permit an authorization to reimburse the treasury "in cases where the applicant shall have kept its accounts and vouchers of such expenditures in such manner as to enable the Commission to ascertain the amount of moneys so expended and the purposes for which such expenditure was made." The Commission has not construed this part of the statute to be mandatory in its requirement that the determination of the amount be based upon vouchers and other regular records, but has used any method of examination capable of displaying the facts, especially where expenditures involved antedated the promulgation of the accounting classification; expenditures made since then and in accordance with the classification can easily be identified in the manner described by the statute. To avoid dispute, some corporations expending large amounts

currently on capital projects and which they will later want to capitalize, have their accounts checked periodically by engineers or accountants for the Commission.

§ 207. (4) Appraisals to Supplement or Check Accounting Analyses

If the accounting method will not determine satisfactorily the amount of capital expenditures paid out of income, nor permit segregation of those representing replacements from those representing additions to, or betterments of, capital, an approximation by an appraisal of the whole property can be made. The total money amount developed by that appraisal, increased by the other assets on hand, will be compared with the outstanding liabilities; the excess of the assets over the liabilities will then represent the earnings retained in the enterprise against which stock or bonds may then be issued.

The term "money amount" of the appraisal is used here because of the ambiguity of other terms; "value" or "cost" are the terms most often employed, but those who use them would be utterly at a loss to give a satisfactory definition of "value," while "cost" may be original cost to the stockholders, or the amount which some investigator assumes should have been the cost to the corporation if it had not done certain things which it did do, or had done certain things which it did not do; or again, it may be "reproduction cost," which is neither cost nor value, nor even what it purports to be—the cost to reproduce—since the facts which might obtain as to reproduction are purely speculative.

It is worth while to digress for a moment and to consider the ambiguity of terms, or the misapprehension concerning the nature of valuations and appraisals of public utility properties. Valuations are much talked of in these days. The Interstate Commerce Commission is now engaged in the task of appraising railroad properties throughout the country—a project which will cost the government and the

railroads at least \$100,000,000 if it is carried to completion. Certain states have appraised or are appraising all public utility properties within their jurisdiction. Such appraisals can be the means of great benefit to both the public and the corporations, but the real nature of the findings must be so stated as to cause no misapprehension. In none of these appraisals is a finding of real "value" involved; a finding of value would, of course, be a finding of one single existing fact capable of demonstration and proof; it would affect the accounts, rates, taxes, etc., and would in turn be affected by them, but it would still remain a single fact the nature of which would be understood alike by all who dealt with it. There cannot, therefore, be one value for rate-making purposes, another for accounting and capitalization, another for the purposes of public purchase, etc. The use of such phrases conveys a wrong impression; one may be careful to specify "value for rate-making purposes," but another will forget the qualification and remember "value" alone.

It is unfortunate that very often a wrong impression is intentionally conveyed; for instance, reproduction cost placed at a figure to be used for a special purpose is compared with the par value of stocks and bonds outstanding for the sake of arousing or fostering prejudice against the company. Sometimes the improper comparison is due simply to carelessness or ignorance. The reproduction cost of a certain railroad reported recently by the Interstate Commerce Commission was compared widely with the company's capitalization. The comparison showed a very great excess of the capitalization over the reproduction cost and in many quarters this discrepancy was taken up as conclusive proof of "water" in railroad capitalization. The fact of the matter was that this company's investments in securities of controlled companies were far more important than the investment in road and equipment, and the greater proportion of its stocks and bonds had been issued to finance the investments in securities. The

Commission's finding of reproduction cost related, of course, only to the road and equipment.

This is a good illustration of the dangers involved in the careless use of the results of appraisals. Hundreds of thousands of investors in railroad securities are awaiting the findings of the Interstate Commerce Commission in its work of appraisal, supposing that the Commission is trying to "investigate, ascertain, and report the value of all the property owned or used by every common carrier," as the law requires it to do, while actually it is not engaged in finding value, but in developing a highly speculative reproduction cost of doubtful value. The work of the Commission cannot be commended or condemned, however, upon the results so far accomplished; there is little doubt that as it proceeds with its work and the facts as to the manner in which its work is being conducted and the results sought to be produced become known, radical changes will need to be made, so that eventually something really worth while may be achieved through its efforts.

These valuations conducted by the Interstate Commerce Commission and other state commissions will have no direct bearing upon problems of capitalization (except indirectly through their influence on rates and earnings) unless they are required to be made the basis for revision of capital accounts. In Chapter XVI was quoted a plea of the Interstate Commerce Commission that a physical valuation of railroads would facilitate a correction of their accounts and balance sheets, but there can be no question that the Commission would now be the first to protest against such a procedure, and the last to admit the propriety of these valuations as a basis for accounting. Where a valuation is made in the course of a capitalization case, however, the accounting will almost always be required to conform to the results of the valuation; the extent to which the New York Public Service Commission of the Second District follows this practice has already been described in § 169.

An appraisal which seeks to determine the amount properly allowable in capitalization to reimburse the treasury for capital expenditures made out of earnings must be limited to investigation of what the property on hand cost the corporation and which it would have been, under the then existing practices, entitled to pay out of the proceeds of stock or bond issues. It is a mistake to base a determination as to this matter upon a statement of "reproduction cost"; such a statement may warrant an issue of stocks and bonds on other grounds, but not for the specific purpose of reimbursing the corporate treasury for capital expenditures made out of earnings. A modification of this method is necessary where only expenditures during a given number of years, e.g., five years described in the New York law, are sought. The amount of stock or bonds which may be issued is necessarily limited to that which will realize an amount corresponding to the actual expenditures made by that corporation, reimbursing its treasury for the amount of the actual outlay. The amount of added capitalization will thus bear no relation to the value of the additions and betterments of plant, but only to the cost they involved.

Public utilities are no longer given the right of estimating the enhanced value of their assets for the purposes of issuing securities against such enhanced values either to be distributed as dividends or used for other purposes. If the utility wants to dispose of any part of its assets it may, of course, do so (subject to such duty as it may owe the public to provide for continuance of operations) and may seek to realize just as much as it possibly can, and the excess of the consideration received over the cost of that asset to it will represent a profit which it may use any way it sees fit. But so long as it holds the properties and is using them, it cannot anticipate a profit from a supposititious sale which may never take place. True enough, this seems somewhat inequitable; the stockholders during a certain period may have used their earnings to build

up the property and may otherwise have so managed the utility that it acquires a high value no part of which they can realize (except in an incidental way through better dividends); they may thereafter retire from ownership and others who have succeeded them may find it possible to dispose of some of those assets. For instance, if the original location of an electric plant has since become valuable because of the growth of the community, the company may find it profitable to change the location of the plant and sell the old site at such a price that over and above the original cost and the expenses of relocation there will still remain a profit immediately available for distribution. The situation is not as bad as it seems, for if stockholders exercise proper care in the study of investment values they will be able to estimate the value of the equity behind their stock certificates, and the market will be willing to allow that value in full.

§ 208. (5) Reimbursement of Proper Expenditures a Matter of Right

If the expenditures for which income is to be reimbursed were for a proper purpose and the amounts spent were in good faith and have been recorded according to the established classification of accounts, the total actual amounts so expended may be capitalized, other measures of value notwithstanding, except that depreciation not fully provided for in the accounts may undoubtedly be deducted from the actual cost. The Nebraska Commission authorized capitalization of actual expenditures amounting to \$129,307.81 for certain properties upon which the Commission's engineer had placed a reproduction value of \$107,686. The applicant accounted for the excess of cost by explaining that the work had been conducted during winter months in the attempt to hurry construction and make the project revenue-earning at an early date, rather than to delay the project for the sake of a somewhat lower cost at the expense of loss in revenue and the possible occupation of

the territory by a competing corporation; the entire cost was allowed by the Commission pursuant to the finding that it was "reasonably required for the purpose for which it was expended."³

The Indiana Commission allowed a capitalization of but \$75,000 out of \$103,000 bonds applied for by an applicant to reimburse the treasury for expenditures in extension and improvements; authority for the remaining \$28,000 was refused because of the Commission's opinion that the improvements represented thereby "will be neither used nor useful for the convenience of the public, for the reason that such property is a duplication of instrumentalities already in existence and in use," owned by another company sharing the territory, "and amply sufficient to supply all the needs of the community, where such property for which the treasury is to be reimbursed in the sum of \$28,000 is erected and constructed." The Supreme Court of that state overruled the Commission, however, holding that if the company proved the facts as to the expenditure, it was entitled to an order for the issue of securities.⁴

It very often happens that when a corporation comes up for authorization to issue stocks or bonds for the reimbursement of income, it adds a number of items to the list of actual expenditures already charged to capital; it may, for instance, ask an allowance for interest during construction, for miscellaneous expenses, etc. The inclusion of such items is within the discretion of the commission; it is doubtful if such allowances can be made, although special considerations may be found fully to warrant their inclusion.

§ 209. Capitalization for Improvement or Maintenance of Service

The New York Public Service Commissions Law author-

³ *In re* Omaha and Lincoln Ry. & Lt. Co., P. U. R. 1916-B, 564.

⁴ *Public Service Commission v. State ex rel. Merchants H. & L. Co.*, 184 Ind. Rep. 273.

izes the issue of stocks and bonds of a public service corporation when necessary "for the improvement or maintenance of its service."

The expenditures here contemplated have nothing to do with the acquisition of property of any kind; they are simply *costs of service*, that is, operating expenses. "Capitalization for operating expenses is in general grossly offensive, yet the statute apparently confers upon the Commission power to permit it."

A newly organized enterprise is allowed working capital out of the proceeds of stock and bond issues to an amount sufficient to defray the costs of service until service produces its own revenue; from that point on, service ought to perpetuate itself, and the revenue should be sufficient to pay the costs of service. Circumstances may at some time develop, however, which will make it impossible for the corporation to pay operating expenses out of the current income. If no other expedient were then available, the enterprise would break down—an eventuality which must be avoided in the case of a public service. The causes producing that situation must then control the remedy which must be either reorganization or the advance of a second instalment of working capital, as it were. Reorganization will be resorted to if there is a fundamental defect in organization or management, or else if the accumulated financial burdens make such demands upon income that it is clearly impossible to make the ends meet. A second instalment of working capital may be properly advanced, and that is the authorization of the statute, where the inability is temporary and there exist no fundamental causes which cannot be cured. Since this is a temporary condition, it will be expected that the moneys procured out of capitalization and used for operating expenses will be returned very soon to the assets of the company in the form of some property, rights, or claims acquired through the use of subsequent income; in precisely the same way that original working capital, while

first used to pay costs of service, will later be found among the corporate assets in the form of property, rights, or claims.

The expedient must be used with the greatest caution. The existence of a situation requiring its use need not necessarily indicate or result in impaired credit, but it may and will often do so, so that the costs of obtaining the moneys desired, i.e., the interest to be paid or discount to be suffered, will present perplexing problems, the determination of which will depend upon the degree of the existing exigency.

If accruing operating expenses may be met out of the proceeds of capitalization, may accrued operating deficits be met in the same way? Both situations represent the insufficiency of income for the costs of service. In the matter of capitalization, however, this difference exists: in the case of defraying present expenses out of the proceeds of stock and bond issues, the aid rendered is assumed to be temporary and future income must make the advance good; in other words, the real remedy for the present inability comes from the revenue of the service the rendition of which is made possible by the help rendered. In the case of capitalizing accrued deficits, there is an admission that income cannot make good the deficiency, and the situation which has been existing is to be remedied from the proceeds of stocks and bonds and not from income, while income will thereafter have to meet the added burden of the increased capitalization.

Attempts to make good accumulated deficits out of the proceeds of stock or bond issues have been quite frequent. Where these deficits represent operations during the period of developing the enterprise, they are in many jurisdictions recognized as proper subjects of capitalization, although they are usually designated by some other name, such as "development expenses." Even here, however, the item is or should be very carefully scrutinized; the mere fact that it covers a period immediately following the commencement of operations is not sufficient to warrant its capitalization, for the venture may

have been foolhardy or improperly conducted; for instance, the company may have sought to operate in a territory which was already adequately supplied. On the other hand, a railroad company may start operating its completed portions of road as soon as possible, wholly at a loss, since its full traffic is unavailable, and the losses will be properly subject to capitalization. In this last instance operations at a loss have reduced other expenses which could have been capitalized.

The capitalization of operating deficits may sometimes be attempted by indirection. There came before the New York Public Service Commission, Second District, an application for authorization to issue \$6,000,000 of ten-year, 4 per cent debenture bonds to discharge debts of approximately that amount due. There was no question that a valid indebtedness existed, the creditor being a controlling corporation; but it also appeared that the operations of the applicant had been conducted at a loss for some years and the Commission concluded that the deficit was represented by the indebtedness sought to be funded, since there was nothing else on the balance sheet to which it could properly be assigned. It accordingly held that "of the existing indebtedness of \$6,062,956 as it stood on December 31, 1908, the sum of \$1,666,452 should not be treated as subject of capitalization."

This deficit, said the Commission, "should be paid out of the first net income arising from operation, and no action should be taken by this Commission which can in the future be construed as warranting the conclusion that it authorized directly or indirectly the capitalization of an operating deficit. Such a deficit must unquestionably be carried along in some appropriate form as an existing indebtedness. If it is once evidenced by long-term securities it will most likely be treated as a funded indebtedness to remain as a permanent charge upon the revenues of the company. When this company has been established upon a paying basis, a condition which it is confidently expected by the management will soon be reached,

the tentative proposition is to convert the securities representing this deficit into common stock entitled to a dividend. This avowed intention of the applicant raises the question, what is the proper disposition of a temporary operating deficit? If it is to be borne by stockholders, the method of treatment is to carry it along upon short-time paper until the net income is adequate for its payment. If money for its liquidation is secured by the sale of stock or bonds which entail a fixed annual charge upon the revenues of the corporation, the dividends upon the stock or the interest upon the bonds become a charge upon the public in the rates which must be fixed so as to produce the sums requisite for such purpose, and the burden of the loss is thus placed upon the public. . . .⁵

"It is true that if debentures are issued for the amount of this deficit running for a term of ten years, and they are then paid from the net income of the company, the result would be the same as if one year notes were issued and renewed annually for the same period, assuming of course the same rate of interest. The difference between the two methods lies in two features: First, the deficit should be paid from the first available income although dividends may thereby be deferred; second, the ten-year debentures will at once be treated as funded indebtedness in accounts of the company and most likely will continue in that class for all time or be converted into stock, which amounts to the same thing."⁶

§ 210. Capitalization for the Discharge or Refunding of Obligations—(1) Funding Operations

Funding and refunding operations must be carried out under the authorization of the statute for issues of stocks, bonds, and other evidences of indebtedness, "for the discharge or refunding of its obligations." The word "obligations" must necessarily be understood to refer only to money obligations. These obligations may consist of floating debt or of

⁵ *Matter of Long Island R. R. Co.*, 2 P. S. C. Rep. (2nd D., N. Y.) 275 (280).

⁶ *Id.*, page 282.

funded debt. The capitalization of the former class of obligations constitutes funding operations, and that of the latter class, refunding operations.

The floating debt of a public service corporation consists of obligations to repay sums borrowed, or to pay for supplies purchased, services received, interest on funded debt, etc. Moneys borrowed will ordinarily be represented by promissory notes, while other obligations will appear in open book accounts.

The issue of notes for moneys borrowed temporarily and for a period not extending beyond one year from date of issue is uniformly allowed without prior authority of a commission. This permission is intended to facilitate the transaction of ordinary business in the course of which purely temporary liabilities would naturally be incurred or loans contracted which are intended to be discharged upon maturity. The projection of commission regulation into every such routine transaction of a corporation would be irritating and even harmful.

The permission is capable, however, of being used for more ambitious purposes and very often as a step in permanent financing. There have been many instances where one-year notes have been issued in amounts so large that their discharge upon maturity was clearly not contemplated, or else they were issued for the purpose of acquiring additions to, or betterments of, capital which would undoubtedly be sought later to be capitalized. It is clear that in these cases the indebtedness itself will outlast the period of one year, although its *indicia* may not; it is palpably evident that in these instances the corporations are attempting to evade the law, and to do by indirection that which they are not permitted to do directly. The law deals with the substance of things and not the form. One purpose of public service commission laws is to regulate capitalization, and the intent is to regulate capitalization at every phase thereof. The technical right of the corporation

to issue one-year notes should therefore not be abused. It would be better if the statutes could be so framed as to allow the exemption only in cases where the indebtedness itself is purely temporary and for routine purposes, but even while the statutes remain as they now are, corporations subject thereto will do well to observe the spirit of the law rather than seek advantage of a technicality. After all, the Golden Rule can be made as important a factor in relations between corporations and commissions as in other human relationships.

It is unfortunate that the use of the exemption for the purpose of evading the statute has sometimes been due to the shortcomings of the regulating commissions themselves; they have often failed to act quickly where quick action was necessary, so that the corporation has been forced to resort to the expedient afforded by this exemption. Moreover, there was noted in these pages an instance where the conflicting decisions of the commissions of two states upon an application for the issue of two-year notes left no alternative but for the applicant to take the entire project out of the jurisdiction of both commissions by substituting one-year notes and issuing them without the authority of either commission.

Abuse of this exemption of the statute can be controlled if limitations are placed upon the repeated renewals of the notes, as has already been done in the laws of some states. In general it is safe enough to rely upon the established banking and commercial usages to prevent any abuse through frequent manipulation of this device; there will be many instances, however, where the lender is a controlling or affiliated corporation which is willing to have the loan stand for a long term of years, the yearly renewals being wholly perfunctory. This controlling corporation may itself be located in another state and by issuing its certificates of indebtedness in its own state where there may be no regulation, or not as strict regulation as in the state where the subsidiary corporation is domiciled, it may for many years finance its subsidiary corporation

which wants to evade the strict laws of the state in which it is situated.

Eventually, of course, indebtedness incurred in any of the above methods will require funding, and the approval of the commission will be sought. The whole question of the purposes for which the moneys were borrowed, the reasonableness of the amounts borrowed, and all of the many considerations involved will need to be considered in retrospect; the application of the moneys derived will then date back so far in the past and have become so intermingled with expenditures from authorized capitalization or from income or surplus funds, that the determination whether the moneys so expended were for value and for purposes described in the law may become very difficult.

The general rule is that the authorization of the statute may be invoked only when the proceeds of the indebtedness to be funded had been applied to purposes described in the law as proper to warrant the issue of stocks and bonds in the first instance. Thus, the mere fact that there appears a present liability for supplies to be used in production cannot warrant payment being made out of the proceeds of stocks or bonds where the supplies have since been used up and their cost charged to the operating expenses; neither would the production of a promissory note entitle the maker to authorization for its funding where the moneys were borrowed for a purpose which would not have been permitted upon an application for direct capitalization.

"Where . . . notes covering the acquisition of property are sought to be refunded by a bond issue, determination of the question whether the capital to be secured by such issue is 'reasonably required' involves inquiry as to the character and use of the property with reference to the general business and public duties of the applying corporation."⁷ "It is apparent that obligations may be issued for other than proper

⁷ Matter of Delaware & Hudson Co., 1 P. S. C. Rep. (2nd D., N. Y.) 243 (276).

corporate purposes and also for purposes which are not the proper subjects of capitalization. The mere fact that obligations exist is not of itself sufficient to justify their capitalization. The purpose for which the indebtedness was incurred, or, to express the idea with greater exactness, the uses made of the funds or property acquired or services rendered as the consideration of such obligations, are material subjects of inquiry. . . . The same discriminating scrutiny should and will be extended to indebtedness as to other subjects enumerated in that statute."⁸

The funding of bond interest is a very unusual expedient, yet it has been allowed in at least one case; there were in that case, however, attending circumstances which place it in a class by itself and destroy its usefulness as a precedent. At the close of 1908 the Erie Railroad Company was described as facing a difficult situation. It was still suffering from the depression following the panic of 1907, and was also trying to recover from a most disastrous and prolonged strike of employees in its mechanical department; it had theretofore undertaken extensive improvements for the completion of which more than \$4,000,000 would be necessary almost immediately, while other important and necessary improvements had to be carried out within a short period; certain equipment trust obligations were maturing annually, and an outstanding issue of \$10,500,000 short-term notes would mature within the next three years. To relieve the situation the company early in 1909 applied to the Public Service Commission for authority to issue \$30,000,000 5 per cent collateral bonds maturing in not exceeding 30 years, to be used in refunding the short-term notes, certain equipment trust obligations, etc., and also to *refund semiannual interest coupons to fall due during the next five years* upon the 4 per cent convertible and general lien bonds, such coupons aggregating \$11,380,000 for

⁸ Matter of Lehigh & Hudson River Ry. Co., 1 P. S. C. Rep. (2nd D. N. Y.) 224 (232).

the period of five years. The coupons were to be deposited with the trustee named in the collateral trust indenture, as security for the bonds to be issued.

The company proposed to fund this interest temporarily by exchanging an amount of the proposed collateral bonds equal in face value to the amount of such coupons, namely, \$11,380,000 par value of bonds for a like amount represented in interest coupons. It was further proposed, however, that both the collateral trust indenture and the order of the Public Service Commission should stipulate and require that the company expend from income during each year of the said five years, an amount upon improvements of the property equal to the face value of the coupons which would have fallen due semiannually; i.e., the company would be relieved of the payment of \$2,276,000 in interest annually and would expend a like sum upon improvements, so that at the end of five years the bonds so exchanged for coupons would all represent capital expended for improvements. The annual interest upon the bonds issued to refund the coupons would be \$569,000, which, deducted from the \$2,276,000 of interest charges thus avoided, would leave net earnings of \$1,707,000, annually released for five years from the burden of interest charges. It is almost superfluous to add that no dividends were to be paid during this five-year period.

The Public Service Commission allowed the requested capitalization for this purpose, deciding that the application came "within the purposes stated in the law for which new or additional capital may be permitted. However inadvisable the course might be, *a bond issue simply to fund a stated amount of interest is not excluded by the statute*, and it would be for the Commission to determine in such a case, as in every case of capitalization sought, whether the capital to be secured by the proposed issue is, under all circumstances, including those pertaining to the issue itself, reasonably required. . . .

"In this case having ascertained that additional capital is

required, we must still determine whether in view of the company's whole situation, financial, physical and operating, the securing of capital indirectly by the funding and temporary avoidance of interest charges is a reasonable means of securing capital for the company's proper corporate purposes. It is not to be denied that such a means of obtaining funds is extraordinary. Nor can it be gainsaid that if indulged in largely by any company, without in some way putting the money into the property and increasing thereby its earning capacity, the policy must lead straight to financial suicide. On the other hand, the temporary funding of interest charges during a period of low returns from operation has been in the past resorted to by carriers as it has been by individuals when in the stress of financial stringency they borrow money for short periods to meet interest payments upon mortgaged real property. In every such case the amount of interest to be refunded, the time covered by the extension, the resources of the mortgagor and ability and methods to apply such resources determine the question of safety and propriety. Here the applicant is seeking approval of the funding of five years' unaccrued interest on two subordinate mortgage liens. Without attachment of conditions such a proposal on the part of a public service corporation should be summarily rejected. The applicant here, however, distinctly meets that fundamental objection by declaring its intention during the five years to put all of that money into appropriate and required improvements of its property by taking an equal amount from its net income, according as the due dates of the coupons ensue, and it shows that its ordinary income with the relief afforded by the refunding of such interest and of the stated note obligations will be amply sufficient for the purpose. It is, moreover, willing that this shall be provided for in the collateral indenture covering the proposed bond issue and that this Commission shall make from time to time any necessary orders in the premises. It is difficult to see how the fundamental objection could be

met more fully. Plainly under such action the objection does not exist, for the funding ceases to be funding in equal amounts each year and at the end of the five-year period it ceases altogether. The bonds exchanged for coupons become as that time elapses bond capital based wholly upon increased property value and stand the same as any other capital issued for that purpose. . . ."⁹

This decision has been very seriously criticized; undoubtedly it was fully within the law, but the wisdom of the expedient used is open to argument. It is doubtful if the Commission itself will ever use it as a precedent. Subsequent to the date of this decision the Commission denied, so far as it involved the funding of interest coupons *matured and unpaid* and aggregating \$403,283, an application for authority to issue bonds for the purpose of retiring certain matured bonds with coupons attached. "No sufficient cause has been shown why unpaid interest . . . should be made a capital obligation,"¹⁰ said the Commission. "The unpaid interest is properly chargeable to income, and the present condition of the finances of the company . . . justifies such payment" (i.e., out of income).¹¹ The headnote of the opinion reads: "Accrued and unpaid interest should be paid from income, and an authorization of bond issue with which to pay such interest denied."

§ 211. (2) Refunding Operations

Funded debt is refunded when its claims upon the debtor are satisfied by exchange for, or out of the proceeds of, a new issue of funded debt, the identity of the debtor remaining the same.

Exchange for, or out of the proceeds of, a stock issue would not constitute refunding; the debt would be completely discharged. To exchange stock, or redeem it out of the proceeds of a bond issue, would be an extremely rare situation, and it

⁹ Matter of Erie R. R. Co., 1 P. S. C. Rep. (2nd D., N. Y.) 471 (487-489).

¹⁰ Matter of Central New England Ry. Co., 2 P. S. C. (2nd D., N. Y.) 205.

¹¹ *Id.*, pages 591, 596.

could not be described as a refunding operation. The Maine Central Railroad Company some time ago proposed to retire \$10,000,000 of its common stock by issuing (1) preferred stock of \$3,000,000, having no voting power, cumulative at 5 per cent, preferred as to assets and callable at 105; and (2) first and refunding mortgage twenty-year, 4½ per cent bonds to the amount of \$7,000,000 par value, dated December 1, 1915. There was no attempt to secure the authorization of the Maine Public Utilities Commission on the merits of the proposed issue as warranted by the Public Utilities Act, for authority to issue these particular securities was expressly conferred upon the company by special legislation of 1915.¹²

The necessity for refunding operations is taken as a matter of course. The larger utilities and practically all the railroads could not by any possible means make adequate provision for the retirement of their funded debt issues upon maturity, so that refunding is continually resorted to. In fact, these corporations would not be permitted by the commissions regulating rates to include in their charges any provision specifically for discharging their funded debts. The inconsistency of the public lies in this, however: that although they will take it for granted that the funded debt will be continued indefinitely in one form or another, they will not give as good support to an issue of extra-long-term bonds which would obviate the expense and inconvenience of refunding as they will do to an issue which in forty or fifty years must be refunded.

Refunding operations may indicate two situations: First, the existence of an immediate claim for payment of a debt through maturity of a bond according to its terms through (a) the expiration of its life, (b) the exercise of some option by the bondholder, or (c) the default in payment of interest, or the omission or commission of some act on the part of the corporation such as will make the entire amount of debt immediately payable; the last condition usually merges refunding

¹² See 1915 P. U. R.-F 1033; *in re* Maine Cent. R. R. Co.

operations into reorganization proceedings. Second, refunding operations may indicate that the debtor corporation has entered upon a project of refinancing, presumably for its own and direct benefit, e.g., by exercising an option to redeem or retire a certain issue prior to maturity, usually because it can place a refunding issue to better advantage than it can continue the outstanding issue. It may also be, and often is, that such refinancing is undertaken by mutual consent of bondholders and the corporation, usually to avoid disastrous receiverships or reorganization.

The cost of discharging or refunding is the most important consideration in the analysis of a refunding plan. The period elapsed since the debt to be refunded was first issued is usually so great that the consideration of the purposes to which the proceeds were originally applied is no longer material, except, of course, where there is a very strong probability that the issue had been made the means of gross overcapitalization. A presumption of proper original issue will usually prevail unless specifically attacked.

The cost of discharging or refunding would include two factors: first, the excess, if any, of the par value of the refunding over the refunded issue; second, the net interest burden of the new issue as compared with the old. In this calculation the discount to be suffered on the new issue of bonds must be considered; if the debt to be refunded has not matured by the expiration of its term so as to be payable at par, the premium to be paid or the market price at which to be repurchased will, of course, also enter into the computation.

It is elementary that the refunding issue shall bear a proper relationship to the debt to be refunded—so elementary that the statutory provision would seem superfluous, yet the provision was inserted in a proposed statute¹⁸ that “in no case shall the amount of securities outstanding be increased by the

¹⁸ Proposed federal bill of 1913 giving Interstate Commerce Commission authority over issue of securities.

refunding." The enactment of any such rigid rule would be extremely unwise. In long-term obligations, the par value might not be of as great importance as the amount of annual interest charge.

The New York Public Service Commission for the Second District in 1908 refused to authorize the issue by a railroad corporation of \$900,000 par value of 5 per cent bonds "maturing not later than 100 years," of which \$500,000 were to be applied to the immediate retirement of an equal amount of unmatured 4 per cent bonds (to mature in 1924). "If the new bonds could also bear 4 per cent interest and be sold to advantage at this time, the immediate retirement therewith of the present outstanding 4 per cent bonds would probably not be open to objection; but the proposal to retire a 4 per cent bond having about sixteen years still to run with a new 5 per cent bond maturing in, say forty years, does not commend itself to this Commission, in the absence of definite and approved arrangements to effect an exchange which would save the company's treasury from any actual loss in the transaction and which would cover the exchange of the whole series of old bonds for the new. In other words, our order should not operate to increase the interest charge upon this property by 1 per cent or any per cent for the next sixteen years without some corresponding increase in the company's assets in property or in cash to be devoted to the construction and improvements covered by the case under consideration. Indeed, it may be questioned whether a present low-interest-bearing bond should be permitted to be retired by a bond bearing higher interest in any event when the present bond would run a reasonable period before maturity. The better course would be, in case $4\frac{1}{2}$ or 5 per cent interest is found necessary for the new bonds, to require that 500 of the new bonds be held in the treasury of the company with which to take up the present bonds at maturity in 1924." ¹⁴

¹⁴ Matter of Greenwich & Johnsonville R. R. Co., 1 P. S. C. Rep. (2nd D., N.Y.) 36.

In connection with another application (decided July, 1908) involving authorization of 4 per cent first and refunding mortgage bonds to retire from time to time outstanding \$5,000,000 7 per cent bonds maturing in 1917, \$500,000 6 per cent bonds maturing in 1924, and \$1,000,000 of 4½ per cent bonds maturing in 1942, the Commission said: "The provisions in the proposed mortgage as to the manner of retiring and finally cancelling these present bonds through exchange therefor of bonds under such proposed mortgage or of purchase thereof from funds in the applicant's treasury, or of sale of the new bonds are approved, but it is evident that during periods of from nine to thirty-four years the terms of possible exchange or of sale of the new bonds must be variable. It is also apparent that the applicant will endeavor to secure the present outstanding bonds from time to time as opportunity may offer. We think that when it has been arranged that any of these new bonds shall be exchanged for any of the underlying bonds, or whenever it is desired to sell any of these new bonds in order to purchase any of the underlying bonds, the terms of exchange or sale should first be submitted to the Commission for approval, provided, however, that such exchange may be made par for par, without payment of any premium on the old bonds by the applicant from its treasury, at any time without such approval."¹⁵

§ 212. The Need for Constructive Regulation of Finance

There is no greater responsibility than that of using other people's money, excepting, of course, that of using their lives. The commercial and financial development which is now valued so highly is based upon faith in the discharge of that responsibility. When that faith fails, crises follow.

The responsible task of corporation finance is that of accumulating other people's moneys for use in corporate undertakings. True, the use is entrusted to directors and officers

¹⁵ *Matter of Delaware and Hudson Co.*, 1 P. S. C. Rep. (2nd D., N. Y.) 242 (271).

representing those who contribute to the capital, at least those who do so through the purchase of capital stock. The sole reason for public regulation of capitalization, however, (the wisdom of which is so amply demonstrated as to require no argument of justification) is that the relationship between those who use the funds and those who advance or loan them cannot and must not be considered as a purely private transaction of no public interest. This is true because in many of its incidents that relationship is charged with or affects the welfare of the public, not only of that small part which may be brought into direct contact with the individual corporate undertaking, but also of the larger part whose vital interests are bound up with the necessity of maintaining financial integrity and supporting credit.

The development of corporations has made possible a great expansion of industry. The building of vast transportation systems, the harnessing of great waterfalls, the girdling of the world with telephone and telegraph lines—all these have been made possible by corporate enterprise supporting personal genius. These have been agencies counting heavily for social progress; those who made the corporate support possible as well as those who supplied the creative genius have been public benefactors, and if the former played such a part when the responsibility of corporation financing rested upon them, it must be that those who are now charged with supervision over similar projects are also charged with part of a like responsibility, to be administered not merely to help some few men to make money, or another group of men to make wise and profitable investments, but rather that social and economic progress may be assured.

Those who plan corporate projects today are achieving just as big things as many of those upon whose past accomplishments we now look back with satisfaction. These men must not be fettered nor handicapped; there must not be in supervision over them men of small caliber who lack vision

and seriousness of purpose, or who are indifferent to their opportunities for public service; above all, there must not be in this responsible position men who cater to prejudice and prostitute the truth to personal expediency and the garnering of notoriety.

It will be said that men of this caliber cannot be attracted to public positions at the salaries which the public can afford to pay; that in private occupations such men make more money. If this were wholly true, then it would be the most potent reason for abandoning attempts at regulation by commission and reverting to the policy of centralizing individual responsibility on those who put themselves in the position of inviting the use of other people's money. It would be better to have no regulation than to have improper regulation. The statement is not true, however, and it has not been true wherever the call has been truly that of a public service; the difficulty has been, and it unfortunately continues to be, that the so-called public service is a branch of politics: party regularity, party support, a willing ear turned to the makers of political destinies, are necessary incidents of sharing therein, and these incidents are obnoxious to the men who want to do big things in a big way.

The public has taken a wise step in initiating regulation over capitalization of public service corporations, but it demands constructive regulation; it does not desire that in checking the abuse of corporate privileges it shall have also dammed and held back the onward course of corporate development; it desires that its commissions shall be governed by laws framed without prejudice and administered without partiality; it expects policies to be chosen with care, and adhered to with justice. Its demands are addressed to those who frame the laws, to those who choose and appoint commissioners, and to those appointed as commissioners to administer the laws.

What is the function of a commission charged with the

responsibility of regulation? Shall it be that of always exercising a negative influence—that of being a cancellation mark? It is well enough to say that it is not a guarantor, but responsibilities cannot be brushed aside by phrases. Why do these commissions exist? A great deal of corporation finance was being administered before their advent with perfect success and absolute integrity. Of course, even with the best of motives and the most conscientious exercises of responsibility there were bound to be differences in opinion as to methods and practices, and the different results achieved sometimes caused misunderstandings and questioning of motives. But taken all in all, so far as the acts of those engaged in this financing were concerned, there was no failure of stewardship and the necessity for regulation was not imperative. There were others, however, who abused opportunities and neglected responsibilities; upon the failure of their stewardship serious public harm ensued, and for the prevention of recurring failures regulation was instituted by the decree that in all financing decisions a vote disinterested and therefore impartial should enter, to the end that stewardship might be more faithfully carried out.

Regulation of capitalization is no more than supervision over the task of corporation finance as above defined; it therefore consists in the exercise of care to see that other people's moneys are invited for proper purposes, under a reasonable and fair arrangement, not in contravention of any public interest, and that they will be properly used for the purposes intended. The commission does not share in the direct responsibility of stewardship, since that rests solely upon the promoters and directors in their relationship to the stockholders and creditors, but it does share in the responsibility for the policy which controls the plan of financing. In what spirit shall it approach that responsibility? On the answer to this question rests the future usefulness of the public service commissions of our country.

INDEX

(References are to pages.)

A

Abandonment,

Restrictions on public service corporations, 20, 157, 170, 183 (See also "Public service corporations")

Accounting,

Accuracy in, important to show surplus applicable to dividends, 116

Defects of, hiding financial status, 116

Discount on—

Bonds issued, 223-4, 363-4 (See also "Discount: bonds, suffered on sale of")

Bonds purchased, 222-3

Stock issued, 75, 76 (See also "Discount: stock, suffered on sale of")

Method of constructing balance sheet, 115

Premium on—

Bonds issued, 225-6 (See also "Premium: bonds, realized on sale of")

Bonds purchased, 225

Stock issued, 75, 76 (See also "Premium: stock, realized on sale of")

Regulation of—

Indirect regulation of capitalization through, 269, 270

Interstate Commerce Commission, 269, 299-301

Public service commissions, 27, 122

Terms, indefiniteness of, 77

Accounts,

Capital in and costs of different kinds of service and territories, detail, 421

Examination of books of, power of commissions, 27, 300

Fixed capital, necessary detail for, 343

Misstatement of, in relation to overcapitalization, 298, 301

Receivable from system corporations, separately shown, 121

Regulation of, as aid to correcting overcapitalization, 299

Restatement of, may be required, 300-1, 343-5

Valuations or appraisals of property as basis of, 339-40, 435

Uniform systems of, established by commissions, 27

Accrued interest on bonds, 220-1

Acquisition of—

Bonds, subsidiary companies,

Economy in financing, 189-90 (See also "Collateral bonds")

Purposes of reinforcing control, 189, 396, 398

Property, plant, etc.,

Authority of state to regulate, in general, 280, 285

Public service corporations to obtain authorization, 26-27

Stock and bonds of other corporations,

Fair value, to be acquired at, and capitalization limited to, 399-401, 403, 404, 406-9, 412

Construction value, when justifiable, 68

What constitutes, 68, 407-9

Acquisition of—Continued**Stock and bonds of other corporations—Continued**

Financing of subsidiary corporations, usual method, 189-90, 396, 399-400

Use of short-term notes in, 444-5

From proceeds of capitalization when obtainable by commission authorization, 286, 404

Intercompany relationships created to accord with public policy, 404

Operation of investing corporation not to be unduly burdened, 404-5, 410

Capitalization issued for this purpose to be identifiable, 405-406

Case of holding companies, 411

Public interest, consideration of, 402-3

Purposes of investment from surplus funds (See "Investments: of public service corporations")

Stock of other corporations,

Authority, general, 94, 396

Requiring consent of commission, 27

Restricted in respect of public service corporations, 27, 94-5, 396

Purposes of control, 399-400

Stock of own issue,

Authority, general, 95-6

Right restricted to purchase from surplus, or acceptance by gift or in settlement of debt, 95

Purpose of restriction, 95

Status of reacquired shares, 95

Actions,

Bondholders', for exercise of remedies, if trustee refuses to act, 174

Stockholders', for declaration of dividends, 130-1

Acts,

Of corporation; proportion of votes required to authorize at stockholders' meetings, 90

Of trustee, binding on bondholders, 174

Actual issue,

Terms defined, relating to stocks and bonds, 39

Additions to fixed capital,

Accounting, 345

Definition, 345

Difficulty of distinguishing from replacements, 431

Affiliated corporations,

Definition of relationship, 395 (See also "Intercompany relationships")

After-acquired property,

Lien of existing mortgage to attach, 167

Distinction between rights of individual and corporation, 167

Methods of deferring lien in special cases, 167

Agency,

Assumed relationship of, between public and public service corporations, 21-2

Of trustee to bondholders, 173-4

Of trustee to mortgagor corporation, 174

Agreement,

Bondholders', for reorganization, 183

Stockholders', apportioning incidents of proprietorship, 84, 104

Voting trust, 88 (See also "Voting trust")

Amortization,

- Bond discount and expense, text of act, 224
- Bond discount and premium, 224-5 (See also "Accounting")
- Funded debt,
 - Advantage to stockholders, 238-9
 - Application of earnings to, 238
 - Burden of, equalizing, 245-6
 - Through serial maturities, 245
 - Through sinking funds, 246
 - Call, bonds subject to, utility in program of, 237, 238
 - Extent to which possible in public service undertakings, 237
 - Methods of, 237-8
 - Necessity for, consideration governing, 238
 - Reacquisition of company's securities, 233 (See also "Redemption of bonds" and "Callable bonds")
 - Refunding does not constitute, 239
 - Required by bondholders, when, 238
 - Security, increased by, 238
 - Serial maturity as method of, 237 (See "Serial maturity")
 - Sinking fund as method of, 237 (See "Sinking funds")
 - What constitutes, 237

Annual report,

- Commission may require, 27 (See also "Reports")

Anti-trust acts,

- (See "Clayton Act")

Apportionment of,

- Control over corporation, between stockholders, 84, 104 (See also "Control")
- Earnings, between stockholder and bondholder, 13, 210
- Ownership rights, a factor in task of corporation finance, 12
- Risk of enterprise, between investors in loan or share capital
 - Interest rate on bonds affected by, 210, 211, 214, 216
 - Proportion of stock to bonds controlled by, 256, 258

Appraisals,

- (See "Valuations")

Appreciation,

- Bond values, 217, 222, 225
- Fixed capital, may not be capitalized, 436-7
- "Writing-up" of accounts, improper use in, 338

Appropriations,

- To fixed capital, out of income or surplus, 129-130
 - Accounting, 129
 - Capitalization for (See "Reimbursement")

Assets,

- And liabilities, constituting balance sheet, 115, 342 (See also "Balance sheet")
- Depreciation of (See "Depreciation")
- Intangible (See "Intangible capital")
- Nature of, affecting characteristics of bonds issued, 193, 231, 245, 250
- Stock preferred as to, 96, 98-9
- Value of, earnings basis of, 74
 - Accounts do not record, 77, 119, 339-40, 342 (See also "Fixed capital: Accounting," and "Investments")
 - Appraisals to determine (See "Valuations")
 - Capitalization limited to, 69, 151

Assignment,

Of bond or stock interest (See "Transfer")

Auction,

Issue of stock by sale at, 70

Authorized capital stock, 32**B****Balance sheet,**

Book values appearing on, 118, 119, 120, 123

Construction of, methods, 115

Difficulties of obtaining accuracy in, 116

Financial status of corporation reflected by, 186-7, 342

Inadequacy of, 116, 118

Solvency, measure of, 118, 342

What constitutes, 118

Statement of assets and liabilities, 115, 342

Bank discount,

Distinguished from true discount, 215

Bankers,

Affiliations with railroad corporations, 151

Attitude towards work of public service commissions, 275

Function of, in corporation financing, 148

Part in developing corporate advantages, 148

Relations with clients, affecting corporations, 148

Bankruptcy (See "Default")**Bearer,**

Payee of coupon bonds, 161

Bearer bonds,

Negotiability of, 163-4

Transfer by delivery, 163

Bearer shares,

Not used in United States, 50

Betterments of fixed capital,

Accounting for, 118, 345

Definition, 345 (See also "Fixed capital")

Blanket mortgage,

Definition, 200 (See also "General mortgage")

Board of Railroad Commissioners (See also "Public service commissions")

Creation of, 25, 309

Powers of, 25, 311

Bond dividends,

Definition, 135

Statutory restrictions on, 135-8

Stockholders' interest in proprietorship converted into claim against corporation.

Bondholders,

- Actions by, if trustee does not act, 174, 181
- Beneficiaries of corporate deeds of trust, 158
- Bound by acts of trustee, 174
- Control over acts of corporation, to reinforce security, 170
 - Conditions of mortgage placing specific duties upon corporation, 171-2
 - Appropriating earnings to maintenance and depreciation, 172
 - Limitations on capitalization, 172
- Contingency of exercising lien, 171, 396
- Contingent, what constitutes, 396
- Limited nature of, 170-1
- Equal rights and benefits of, 158-9
- May not proceed as individual creditors, 158
- Option to exercise remedies, 181
- Purchase of mortgaged property by, 183
- Remedies of, on default of corporation (See "Remedies of bondholders")
 - Exercise of, subject to public policy, 168, 170, 183
 - Exercise of, through trustee, 159, 181
 - Bondholders may direct action of trustee, 181
 - On default of trustee, bondholders may act, 174, 181
 - Resort to, constitutes distributing element in corporation finance, 255
- Stockholders distinguished from, 210-11

Bonds,

- Agreement of, incorporated in trust deed, 159, 162
 - Parties to, 160-161
 - Promise to pay principal and interest, 159-60
 - What constitutes, 158
- Amount of issue of, in relation to capitalization (See "Proportion between stocks and bonds")
 - Limitations of mortgage on, 172-3
 - Restricted, per mile of road, 177
- Apportionment of incidents of ownership represented by, 12-13, 147, 210
- As collateral (See "Collateral bonds")
- As personal property, 206
- Authority for issue (See "Borrowing money")
- Certification of trustee required, 161 (See also "Certification of bonds")
- Characteristics of, controlled by nature of property mortgaged or purpose of issue, 193, 231, 245, 250 (See also "Equipment obligations")
- Classification of, according to—
 - Form, 161 (See also "Coupon bonds" and "Registered bonds")
 - Method of redemption, 186
 - Property mortgaged, 185
 - Purpose of issue, 186
 - Ranking order of liens, 186
 - Security, 185, 187
 - Terms in years, 186
- Convertible, 186, 235
- Coupon, 161 (See also "Coupon bonds")
- Debenture (See "Debenture")
- Definition of, 152
- Definitive, 160
- Denomination of, amount, 153 (See also "Denomination of bonds")
 - Currency in which stated, 159-160
- Dividends (See "Bond dividends," above)
- Domicile of, 212
- Equipment, 192 (See also "Equipment bonds" and "Equipment obligations")
- Execution of certificate for, 161

Bonds—Continued

- Financing by issue of, place in corporation finance, 12, 147 (See also "Trading on the equity")
- Guaranty of, by another corporation, 206
- Interest on (See "Interest")
- Interchangeable, 162
- Interminable, 229
- Issue of, to be authorized by commission, 27 (See also "Regulation of stock and bond issues")
- Legal investments, 200, 266
- Market for, compared with stock, 254
 - Effect on determining proportion to stock, 265
- Maturity, no date of (See "Irredeemable bonds")
- Mortgage to secure (See "Mortgage" and "Security for funded debt")
- Negotiability of, 152, 163-4
- Non-negotiable, when, 152
- Notes and, compared, 152
- Par value of (See "Denomination")
- Payee, bearer of coupon bonds, 161
- Payee, named on registered bond, 162
- Payment, terms of, indicated by bond titles and classified according to, 186
- Proportion to stock, 251 (See also "Proportion between stocks and bonds")
- Purpose of, indicated by bond titles and classified according to, 186
- Reacquired, status of, 247, 249
- Redeemable, 186 (See also "Redeemable bonds")
- Refunding, 201
- Registered, 161-62 (See also "Registered bonds")
- Serial, 186, 239 (See also "Serial maturity")
- Stock distinguished from, 152-3
- Straight, 186, 239
- Taxation of, 206-207 (See also "Taxation")
- Taxes on, income from, assumed by corporation, 160, 208-9
- Temporary, 160
- Terminal, 186, 188
- Term of, 186, 229 (See also "Term of bonds")
- Unauthorized, void by statute, 275
 - Penalties for issue, 275
- Validity of, laws of state governing, 149, 280

Bond titles,

- Ambiguity of, 185, 198
- Property mortgaged, indication of, 185-6
- Purpose of issue, indication of, 186
- Ranking order of liens, indication of, 186
- Reinforced security, indication of, 187
- Significance of, 185
- Terms or method of payment, indication of, 186-7

Bond values,

- Appreciation or depreciation in, if purchased on basis rate, 217, 222, 225
- Ignorance of, as cause of undue proportion of bonds in financing, 254
- Income as test of, 219, 221
- Serial maturities, causing variation in, 239

Bonus stock,

- Issue of, 58
- Rights and liabilities of holder, 57
- Stock-watering, 58

Books,

- Of account, jurisdiction of commission over, 27
- Examination of, must be thorough if used as basis of restatement, 300
- Stock (See "Stock: book")

Book surplus,

- Distinguished from "real," 118-20
- Relation to determination of profit, 123

Book value,

- Of fixed capital, 118-120

Borrowing money,

- Authority for (See subhead below, "Power of contracting debt")
- Exercise of right, laws of state governing, 149
 - Regulation of, by charter, 280, 284-5
 - Regulation of, by statute, 151, 273
- Function of, in corporation finance, 147, 255 (See also "Trading on the equity")
- Limitations on amount, 151
- "Loan capital," for accumulation of, 148 (See also "Loan capital")
- On bond issue, 151
- On credit of corporation, 154
- Payment of dividends, 132-3
- Power of contracting debts and, 12, 148, 280, 284-5
- Security given by corporation, 154 (See also "Mortgage" and "Security for funded debt")
- Sources available for, 151, 154

Bribe,

- Exercise of voting rights under, 86-7

Bridge bonds, 186, 188

Bridge companies,

- As public service corporations, 17

Bubble Act,

- Enactment of, 4

Burden of Amortization,

- Equalization of, necessary, 245
- Serial maturities effecting, 245 (See also "Serial maturity")
- Sinking fund effecting, 246 (See also "Sinking fund")

Business,

- Expansion of, affecting development of corporations, 12

By-laws,

- Classification of capital stock in, 97
- Corporation, management of, regulated by, 85
- Stockholders' rights, limitations, 84

C

Call,

- Bonds subject to, 186, 233 (See also "Callable bonds")
- Stock subject to, 108 (See also "Callable preferred stock")
- Subscription agreements, payments on, 43

Callable bonds,

- Advantages of to corporation, 233
- Definition, 186, 233

Callable bonds—Continued

- Disadvantages to bondholders, 234
 - Compensation for, by payment of premium, 234
 - Effect or possible appreciation of bond value, 234-5
- Drawing by lot, 234
- Utility in program of amortizing debt, 238

Callable preferred stock,

- Computation of yield, 221
- Definition, 100, 108
- Premium paid on, 108

Capital,

- Accumulation at organization, 31
- Building up out of earnings, 129-30, 336-7 (See also "Income: appropriations for fixed capital investment")
- Capitalization and, compared, 267, 269
 - Impossibility of maintaining comparative values, 296, 299
 - Proper relationship required by statute, 260-1, 302
- Capital stock and, compared and distinguished, 31, 32-3, 34, 54
 - Attempt to maintain comparability of, in accounting, 64, 338
- Classification of, fixed and floating, 335-36
 - Accounting, necessity of maintaining distinction in, 267
 - Rule to distinguish, 335-6
- Definition, 31, 32, 335
- Distribution of, among stockholders, 95, 113-4, 124 (See also "Dividends")
- Facility for accumulating, an advantage of corporate form, 31
- Invested, integrity of to be maintained, 288, 307
- Loan (See "Loan capital")
- Share (See "Share capital")

Capitalization,

- Abuses of, commission regulation to remedy, 295
 - Methods of correcting, 295-6
 - Propriety of acts at time committed to be considered before condemning, 305
- Acquisition of stocks and bonds; expenditures subject to, 286 (See also "Acquisition")
- Appraisals of company's property in relation to (See "Valuation")
 - Care to be used in making comparison, 434-5
- Capital and, compared, 267, 269
 - Impossible to maintain comparative values, 296, 299
 - Proper relationship required by statute, 260-1, 302
- Collateral aspects of regulation over, 308
- Construction costs (See "Construction")
- Deficits, improper, 440-2
- Definition of, 286, 289
- Development expenses, 440
- Direct regulation, what constitutes, 268-9
 - Exercise of by state commissions (See "Regulation of stock and bond issues")
 - Purpose of statutes conferring, 288-9
- Existing, correction of alleged improprieties (See also "Overcapitalization")
 - Paring down of securities, impracticability of, 295-6
 - Power of Commissions to attempt correction, 294-5
 - Direct powers not retroactive, 294-5
- Federal regulation of, indirect, 269 (See also "Interstate Commerce Commission")
 - Attempts to give power of direct regulation, 270-2

Capitalization—Continued

- Fixed capital, financing acquisition of (See "Fixed capital: capitalization for purposes of")
- Funding operations, incident to (See "Funding operations")
- Increase of, considerations controlling,
 - Alleged overcapitalization (See "Overcapitalization")
 - Examination of accounts, 300
 - Financial condition of corporation, 303
 - Limitations upon inquiry, 304
 - Past record of corporation, 303-4
 - Arbitrary use of, to be avoided, 305
- Indirect regulation of, what constitutes, 269, 274-5
 - Exercise of, by state commissions, 274-5
 - Interstate Commerce Commission, 269
- Intangible capital, acquisition (See "Intangible capital")
- Investments not subject to, 406, 413-4
- Issue of, authorization of commission required, 27, 34, 279, 284
 - Penalties for unauthorized, 275
 - Right declared to be a special privilege, 283-4
- Limitation upon amount, based on value of assets, 69, 151, 296, 302
- Operating expenses, capitalization for when allowed (See "Maintenance or improvement of service")
- "Outside properties," investments in, not subject to, 414
- "Overcapitalization," effect of on proposed additional (See "Overcapitalization")
- Par value of, distinguished from investment in capital, 268
- Probable return on, proper for commission to consider, 292, 327-8
- Proceeds, application of to purposes specified by commission, 27, 178, 286 (See also "Proceeds of capitalization")
- Public service corporations, public interest in, 267-8
- Purchase of plant, for purposes of financing (See "Purchase of plant")
- Purposes for which intended,
 - Aspect of capitalization best regulated, 274
 - Control issue, 289
 - Enumeration of, general, 286, 296
 - New York statute, 286-8, 296
 - Examination of, by commission, 286
 - Importance of carefully considering, 267
 - Regulation of, 274
- Rates and, relationship between, 267-8, 320-323
- Reasonableness of, 290
- Refunding operations, incident to (See "Refunding operations")
- Regulation of, demand for, 267 (See also "Regulation of stock and bond issues")
- Reimbursing income out of, for moneys expended on fixed capital, 426 (See also "Reimbursement")
- Reorganized corporation, 422 (See also "Reorganization")
- State,
 - Express declaration, California, 326
 - Jurisdiction of, overcapitalization (See "Stock and bond issues, jurisdiction of commissions")
 - Not a guarantor of authorized, 322, 325
- Statute, regulation by, 69, 151, 273
- Tangible capital, acquisition (See "Tangible capital")

Capital stock, (See also "Stock")

- Authority for issue of, 34, 279, 284
- Authorized, definition, 32
- Balance sheet, entered on at par, 55

Capital stock—Continued

- Capital and, compared, 31, 32-3, 34, 54
- Certificate of, 32 (See also "Certificate")
- Classification of, 34, 96
 - Authority for, generally, 96-7
 - Consent of commission, when required, 97
 - Divergent interests introduced by, 105
 - Effected by charter or by-laws, 97
 - Effect of, 96
- Common (See "Common stock")
- Credit, issue of, as representing extension of credit, 57, 297-8 (See also "Credit")
- Definition, general, 32-3, 370
 - For purposes of taxation, 51
- Dividend payments out of, prohibited (See "Dividends")
- Founders' shares, 110
- Increase of, 35
- Interest-bearing, 109
- Issue of, to be authorized by commission, 27 (See also "Regulation of stock and bond issues")
 - Consideration to be realized (See "Consideration")
 - Expenses of, proper charge to capital, 362
 - Implied powers of corporation to make, 11-12
 - Inherent in corporate form, 12, 34, 47, 279
 - Unauthorized, void by statute, 275
 - Penalty for issue of, 275
 - What constitutes, 38, 39
- New, offered to stockholders of record, 263
- Obligation of corporation for, 32-3, 49, 54, 99-100, 152
- Par value of (See "Par value")
- Proprietorship indicated by, 33-4, 36 (See also "Stockholders: proprietorship")
- Redemption of, out of bond issue, 449-50
- Reduction of, 35
- Shares of, 32 (See also "Shares")
- Special classes of, resembling creditors' claims, 100, 109-10
- Subscriptions for (See "Subscriptions")
- Taxation of, 51 (See also "Taxation")
- Transferability, essential characteristic of, 47 (See also "Transfer: shares of capital stock")
- Validity of, laws of state governing, 279
- Value of, 33
 - Corporate surplus or deficit, balance of, relation to, 33-4 (See "Corporate surplus or deficit account")
 - Par value compared with real, 55, 64-5, 72, 76-8, 298
 - Taxation purposes, 51-2
- Withdrawal of by stockholders, prohibited, 95

Carrier and non-carrier,

- Properties distinguished, 414

Car-trust bonds, 192**Car-trust certificates, 192****Certificate of capital stock,**

- As personal property, 47, 51
- As receipt, 32, 34
- Book record to be kept of issue, 37

Certificate of capital stock—Continued

- Definition, 32
- Delivery, effect of, 39
- Execution of, 38
- Form and recital of, 32, 37, 47
- Negotiability of, 49, 50
- Shareholders' contribution and interest, evidenced by, 34, 36
- Transfer of (See "Transfer: shares of capital stock")
- Transferor and transferee, rights of, in respect of dividends, 47
- Transferor of, warranties to transferee, 50

Certificate of deposit,

- Issued to members of voting trust, 88

Certificate of incorporation, (See also "Charter")

- Authority for execution of (See "General laws, incorporation under")
- Capital stock, provisions contained in, 34
 - Classification, 34, 97
 - Reasonable restrictions on ownership of shares, 47
 - Voting rights of stockholders, 84
- Corporate charter, 11
- Filing of, requirements for, 11
- Incorporation effective on filing, 11
- Incorporators, qualifications of, 1, 2, 3, 94

Certificate of indebtedness (See "Bonds," and "Notes")

Certificate of interest (See "Shares without par value")

Certificate of public convenience and necessity,

- Commission to grant before railroad may be constructed, 26
- Conditions leading up to regulation of, 309-12
- Regulation to prevent construction of bankrupt roads, 321

Certificate of voting trust, 88

Certification of bonds,

- Conditions precedent, 176
- Limitations upon amount per mile of road, 177
- Purpose of requiring, 175-6
- Responsibility of trustee in making, 177
- Trustee to make, 161, 175

Charter of corporation, (See also "Certificate of incorporation")

- Definition, 367
- Early history of, 3-4, 9-10
- Grantees, natural persons, 1, 2, 3, 94
- Grantor, generally, 1, 8
 - Federal government as, 9
 - State as, 9-11
- Management of corporation regulated by, 85
- Power of amending, reserved by state, 11, 278-9
- What constitutes under general laws, 11

Chattel mortgage,

- Definition, 155, 165
- Personal property lien, 155, 165
- Pledge, distinguished from, 155

Circulating capital (See "Floating capital")

Civil corporations, 6, 7 (See also "Stock corporations")

Clayton Act, 29, 30**Closed mortgage, 160****Collateral bonds,**

Convertible, 191

Definition, 186-7, 189

Financing projects of subsidiary corporations by, 189-90, 396, 399

Fixed charges substituted for dividends on stock collateral, 401, 430

Necessitated by restrictive state laws, 397-9

Security for, classification of collateral, 189

Bonds of subsidiary corporations, 189-90, 396, 399

Mortgage incidence, 190

Company's own bonds, 189, 191-2

Custody of trustee, 178-9

Foreclosing lien on, 180

Income from disposition of, 179-80

Return on, relation to interest rate of issue, 179, 401, 410

Right of substitution, 191

Securities not of subsidiary companies, 189, 190-1

Effect on term of bonds, 191

Stock held as collateral, 189, 399-400, 401, 412

Voting rights on, by whom exercised, 179-80

Trustee, duty of, in connection with, 173-4, 179

Value of, if consisting of securities of subsidiaries, 190

Collateral mortgage bonds, 190**Collateral trust bonds (See "Collateral bonds")****Collateral trust notes, 191****Combinations (See also "Consolidations," and "Intercorporate relationships")**

Public policy, 404-5

Restrictions on, 396 (See also "Clayton Act")

Through holding company, 411

Stock ownership, 399-400

Commissions,

Gas and electricity, New York, 312

Regulation by (See "Public service commissions")

Sale of stock, payment, 71, 76

Committee,

Bondholders', reorganization proceedings, 183, 423

Stockholders', to secure concerted action, 89

Common carriers,

Classes of, 17

Definition, 15, 16

Private carriers distinguished from, 16

Public service corporations, 17

Special duties of, 15-6

Common stock,

Classification, instance of, 98

Conflict of interest with preferred, 105

Control, solely vested in, 106-7

Limitations upon, in favor of preferred stockholders, 106

Definition, 97

Equal rights of holders, 98

Competition,

- Existing enterprises to be protected from (See "Existing public service Enterprises")
- Free, in public service field, effects of, 24, 309-12
- Consolidation of competing companies resulting from, 308
- Regulation of, 26, 309, 321

Concerted action of stockholders,

- Difficulty of obtaining, 89
- Minority control arising from absence of, 89-90
- Pooling arrangements to obtain, 88, 89

Condemnation, power of,

- Definition, 310
- Grant of, unrestricted, effects, 24, 310
- Improper use of by private corporations, 24
- Regulation, necessity for, 24-5, 310, 321

Conditional sales,

- Distinguished from chattel mortgage, 194
- Equipment trust obligations, use in, 194

Congress,

- Authority to create private corporations, 9
- General laws of incorporation, power to enact, 9
- Interstate commerce controlled by, 9, 28
 - State jurisdiction, compared, 28
- Post-roads controlled by, 9, 29

Consideration realized on issue of securities,

- Amount of (See "Price of issue")
- Cash, when required, for payment of stock, 42
 - Forms other than, purpose of allowing payment, 41-2
- Contribution of definite form of capital necessary for issue of stock, 40
- Nature of, generally, 41
- Promissory note not good, for capital stock, 42, 43-4
- Property, labor, or services, 41-2
 - Value to be determined by directors, 41-2, 59-60, 301
 - Constructive, when justified, 67-8
 - Determination, difficult if directors are parties in interest, 42, 60
 - Fraud, allegation of, necessary to impeach, 59-60
 - Elements of, required to exist, 60-1
 - Personal interest, attempt to eliminate, 61-3
 - Review of independent tribunal, 63
 - Publicity of incidents of issue, 61-2, 63
 - "Stock-watering," alleged, 58-9 (See also "Watered stock")

Consolidated and general mortgage bonds, 201

Consolidated first mortgage bonds, 201

Consolidated mortgage bonds, 186, 200-1

Consolidated refunding mortgage bonds, 201

Consolidations (See also "Combinations")

- Accounting of new company, special consideration of, 421
- Anti-trust laws, application of, 419
- Capitalization not to be increased by, 417-8
 - New York statute, 417
 - Purpose of prohibition, 417-8
 - Value of consolidating properties to control, 428

Consolidations—Continued

- Contract of, not subject to capitalization, 375
- Definition, 416
- Exchange of securities in, basis of, 418
- Overcapitalization of consolidated company to be avoided, 419
 - Condition of consolidating companies may be examined, 419-20
- Public policy to be considered, 332, 404, 420-1
- Regulation of, by commission, 419
- Sale of properties by two or more companies to common purchaser equal to, 419

Constitution,

- California, definition of public utility, 18
- Delaware, consideration for issue of stock, 41
- New York, incorporation under general or special laws, 10-11, 279
- United States,
 - Interstate commerce clause, 28-9
 - Post-roads clause, 29

Construction,

- Capitalization for costs of, 379
 - Determination of amount, estimates used, 379 (See also subhead below "Costs of")
 - Fluctuations to be provided for, 379-80
- Costs of, what constitutes, 341, 381 (See also "Cost")
- Accounting for detail of, 380 (See also "Fixed capital: accounting for")
- Apportioned between operation and construction, 385
- Estimate of, for capitalization, 379, 383-4
- General and overhead expenditures entering in, 381
- Engineering and superintendence during, 381
- Injuries during, 382
- Interest during, 383
 - Amount of, 385-6
 - Payment of, out of stock, 386-7
- Law expenditures during, 382
- Miscellaneous expenditures during, 383
- Operations during, accounting for, 384-5
 - Apportionment of costs to, 385
 - Loss from, disposition of, 385 (See also "Development expenses")
- Period of, what constitutes, 384-5
- Taxes during, 382
- Under contract, general considerations, 387, 388
 - Abuses of capitalization introduced into, 387-8
 - Accounting for, 389
 - Profit of contractors, legitimacy of, 389
 - Terms of agreement, review by commission, 388-9

Construction companies,

- Definition, 387
- Financing through, 387-8
 - Abuses checked by commission regulation, 388

Contractors' profits,

- Legitimacy of, in cost of construction, 389

Contract rights,

- Capitalization of,
 - Abuses in, 374-5
 - When warranted, 375
- For lease or consolidation, may not be capitalized, 375

Contract rights—Continued

- For purchase of electricity at advantageous rate disallowed, 375-8
- Intangible capital, 338

Control,

- Bondholders' (See "Bondholders")
- Contingent, 106
- Corporation, exercising over another corporation (See "Controlling corporation")
- Definition, in intercorporate relationships, 394-5
- General, 105-6, 396
- Joint, what constitutes, 395
- Majority stockholders, 89 (See also "Majority control")
- Minority stockholders, representation in (See "Minority representation")
- Over corporation vs. over property of corporation, 394
- Right to name majority of board, by agreement, 395
- Sale, what constitutes, 395
- Specific, 106
- Stockholders' (See "Stockholders")
- Unified, advantage of corporate form, 31

Controlling corporation, (See also "Holding companies")

- Acquisition of stock for purposes of control, 399-400
- Affiliated corporations, definition, 395
- Capitalization of, for financing subsidiaries (See "Acquisition of: stock and bonds")
- Relationship to subsidiary companies (See "Intercorporate relationships" and "Control")
- Special responsibilities to minority stockholders, 92
- Value to be placed on securities held as means of control, 120

Conversion, right of,

- Bonds, 186, 235
- Registered and coupon bonds, 161-2
- Stock, 107-8

Convertible bonds, 186, 235

Convertible collateral trust bonds or notes, 191

Convertible preferred stock, 107-8

Corporate enterprise,

- Personal relationship of members entering into, 2, 31

Corporate existence,

- Change in membership does not affect, 1, 3, 12
- Term of, 1, 8

Corporate name,

- Implied power of corporation to do business in, sue or be sued in, etc., 12

Corporate surplus or deficit account, (See also "Deficit," and "Surplus")

- Definition, 117
- Function of measuring solvency, 116, 118, 342
- Matters entering into, 117
- Proprietorship, index of, in conjunction with capital stock, 33-4, 55
- Profit and loss account of industrial corporations compared, 117 (Note)

Corporation commissions (See "Public service commissions")**Corporation finance,**

- Elasticity of, 288
- Influences bearing on development of, 12
- Instruments of, 12-13
- Stock corporation, limited to affairs of, 7
- Task of, 13

Corporations,

- Advantages of organizing into (See "Stock corporations")
- Charter of (See "Charter," "Certificate of incorporation," and "Incorporation")
- Classification of, into public and private, 6
- Definition, general, 1-3
 - Legal statement of, by Supreme Court, 1
- Development of, 12-13 (See also "Joint-stock associations")
- Government of officers, agents, and business, by by-laws, 12
- Independent entity, 1
- Private, 614, 267
- Public, 6
- Public service, 14 (See also "Public service corporations")
- Stockholders in other corporations, 27, 94-5, 396

Cost,

- As basis of accounting for fixed capital, 77, 119, 337, 340-1
- Construction (See "Construction")
- Detail to be recorded, 343-4
- Capital in service, total to be shown, 345
 - "Last cost," meaning of, 356
- Definition, 341
- Indefiniteness in use of term, 433
- Items entering into, 341, 381 (See also "Construction")
- Replacements, 118, 303-4, 355
- Reproduction (See "Reproduction cost")

Coupon bonds,

- Bearer is payee, 161
- Collection of interest on, 161, 162
- Definition, 161-2
- Principal and interest registered, method of, 163
- Registered, 163
- Registered bonds issued in exchange for, 162
- Transfer by delivery, 161
 - Ease of, causing preference for, 164

Coupons, (See also "Coupon bonds")

- Detached and retained by corporations as method of registry, 163
- Interest collected by, 161-2
- Payable to bearer, 162
- Promissory notes, 162
- Signature of corporation's treasurer, 161

Credit,

- Established, regulation to protect, 330, 332
 - Controlling competition for purpose of, 324 (See "Existing public service enterprises")
 - Required revision of accounts must consider, 300
- Expansion of, effecting development of corporation finance, 12, 147-8

Credit—Continued

- Inflation of, through stock or bond issues, 57, 297-8 (See "Overcapitalization")
- Effect of successive sales of stock at inflated values, 58, 298
- Interest or dividends, default in, effects compared, 401
- Investors in, bondholders as, 12
- Of corporation,
 - Price of stock issued controlled by, 72-3, 74
 - Security for bonds, consisting of, 154
 - Effecting term of bonds, 231

Creditors,

- Classes of stock purporting to confer rights of, 100
- Debtors and, relation between, 100
- Preferred stockholders not, 99-100
- Prohibition of, affecting theory of capital stock issues, 56
- Stockholders, no recourse against, for corporate debts, 56 (See also "Limited liability")
- Exception of wages, 8, 56

Cumulative preferred stock,

- Definition, 103
- Effect on subordinate classes of stock, 103-4
- Past-due dividends not interest-bearing, 103

Cumulative voting,

- To give minority representation, 93-4

Currency bonds, 236**D****Debenture bonds,**

- Definition of, use in England, 170, 203
- Secured on corporate undertaking, 170, 203

Debenture income bonds, 203**Debenture stock, 111, 204****Debentures,**

- General use to denote unsecured issues, 202, 203
- Significance of term as used in England, 203
 - Mortgage, 204
 - Registered or to bearer, 204
 - Simple, 203

Debt,

- Amortization of (See "Amortization of funded debt")
- Capital stock not a, of corporation, 32-3, 49, 54, 99-100, 152
- Classification into funded and unfunded, 149
 - Basis of, term in years, 149-50
- Lien of, upon property of corporation, 155 (See also "Liens")
- Permanency of, acquired for capital purposes, 228-9, 236
- Power of corporation to contract (See "Borrowing money")

Declaration of dividends, (See also "Dividends")

- Courts loath to review action of directors, 130
- Dates for, how fixed, 146
- Directors to declare formally, 112-3, 129
- From surplus, 112-3
- Shareholders' control over, in other countries, 112-3
- Stockholders' right to demand, 130-1

Default, (See also "Bondholders: remedies," and "Remedies")

- Of corporation on bond agreement, what constitutes, 180
- Remedies of bondholders to be exercised upon, 166, 171

Deficiency judgment, 155**Deficit,**

- Capitalization of, not allowed, 440-2
- Excepting accrual during construction period, 385, 440

Definitive bonds, 160**Denomination of bonds,**

- "Baby" bonds, 154
- Considerations controlling, 153-4
 - Economy of handling, 153
 - Marketability, 153-4
- "Face value" preferable to "par value," 153
- Par value as measure of corporate liability on bond, 152
- Registered bonds, 154
- Translation into foreign currency, 212

Depreciation of fixed capital,

- Accounting, to effect even distribution of costs, 354
 - Neglect of, 351
 - Proper treatment important, 118, 119
- Accrued, reserve for, accounting, 354
 - Balance sheet, 119, 354
- Accruing, charge to operating expenses, 351
 - Instructions for accounting, 353-4
 - Necessity of accounting for as part of production cost, 350
 - Omission of formal accounting, argument for, 352
- Amount of, important to determine accurately, 351
 - Detailed accounting of fixed capital necessary as basis, 343-4
 - Effect of errors in estimates, 352-3
 - Method of ascertaining, 352, 354
- Definition, 350
- Expense of, defined, 353
- Intangible capital, 359
- Nature of, 118, 348-50, 353
- Rate of, considerations to control determination of, 354
- Relation to serial bond maturity, 193, 243-4
- Reserve for, mortgage requirements, 172

Development expenses,

- Capitalization for, 440
- Proper charge to capital, conditions supporting, 385

Directors,

- Authority of, to manage corporation, 12, 31, 84-5
- By-laws to regulate acts of, 85
- Cumulative voting for election, 93-4
- Declare dividends, 112-3, 129
- Judgment of value of property acquired conclusive, 301 (See also "Consideration realized on issue of securities")
- Misdemeanor of, to permit withdrawal of stockholders' capital, 42
- Resolution of, authorizing bond issue, incorporated in trust deed, 158
- Right to elect majority of, representing preferment in control, 106

Discount,

- Bonds purchased at, accounting for, 222-3
- Bonds sold at,
 - Considerations governing, 215-6
 - Disadvantage of too great a discount, 217-8
 - Regulated by commission fixing price of issue, 218, 364
- Bonds, suffered on sale of,
 - Accounting for, 223-4, 226, 363
 - Not chargeable to capital accounts, 362-3
 - Opinions holding to propriety of charging capital, 363-4
 - Cost of borrowing, part of, 216, 363
 - Definition, 215, 362
 - Expenses of issue combined with, 362
- Stock, realized on sale of,
 - Accounting for, 75-6
 - Balance sheet to show, 75
 - Bond discount compared, 72
- Stock sold at,
 - Authority of law required to permit, 70-1
 - Considerations warranting, 70
 - Preferable to bond issue, when, 73
 - Regulated by commission fixing price of issue, 70-1
 - Statutory provision limiting amount, Massachusetts, 70
 - "Watered" stock distinguished from, 70

Discrimination,

- By common carriers, 15-6
- Free service to municipalities constituting, 369
- In public undertakings prohibited, 15

Dividend-on,

- Sale of stock at, 146, 221

Dividends,

- Amount of, expressed as per cent of par, 72
- Bond, 135-8
- Capital not to be paid out as, 95, 113-4, 124
 - Application of rule where capital has been impaired, 124-6
 - Exception of wasting assets, 127-8
 - What constitutes payment out of, 123-7
- Corporation may not guarantee, 109
- Declaration of (See "Declaration of dividends")
- Definition, 112, 137, 152-3
- Maintenance of, desirable, 115
- Ownership vested in real owner of stock, 47
- Payment,
 - Borrowing money for, 132-3
 - Dates for, 146
 - Mediums used for, 131-3
 - Consideration other than cash, when used, 132
 - Right of preferred stockholder to demand cash, 132, 133
 - Stockholder may not choose, 132
- Property distributed as, 145-6
- Scrip, 133-5
- Stock, 138-145 (See also "Stock dividends")
- Surplus profits, from, 112-3
 - Proportion to be divided, 127

Dividends—Continued

Yield, net,

Computation, 219-21

Definition, 219-20

Divisional bonds, 185, 188**Dock bonds, 188****Domestic corporations,**

Nature of jurisdiction over, of incorporating state, 276, 284 (See also "Regulation of stock and bond issues")

Domicile,

Corporation's, 149

Of bonds, 212

Of shares, 52

Duplication of plants, (See also "Competition")

Incident of competition in public utility enterprises, 308

Results of duplicating investment, 308, 312

Usually followed by consolidation or merger of competitors, 308

Purpose of regulation to prevent, 312

E**Earning power,**

Index of value of corporate assets, 74, 299

Valuations based on, impracticable for accounting purposes, 337-8

Ecclesiastical corporations, 6, 7**Eleemosynary corporations, 6, 7****Eminent domain (See "Condemnation, power of")****England,**

Companies Act (See subhead below, "Prospectus")

"Debenture," meaning with which used, 203-4

Prospectus Act, 63-4, 65

Urged for adoption in the United States, 65, 69

"Shares" and "stock," meaning with which used, 111, 204

Equipment bonds, (See also "Equipment obligations")

Conditional sales as basis of security, 194

Definition, 192, 193

Trustee, title vested in, 194-5

Equipment obligations,

Characteristics of, affected by nature of property by which secured, 192-3

Classification of, 192

Definition, 192

Lien of, how enforced, 196-7

Purpose of issue, 192

Security for, basis of, 197-8

Serial maturity, 193 (See also "Serial maturity")

Equipment trust certificates,

Definition, 192, 195

Earliest form of equipment obligations, 195

Guarantee of a railroad corporation supporting, 196

Interest in unincorporated association, represented by, 195, 196

Security for, 195

Equity,

- Stockholders', in corporate assets, 54, 76 (See also "Stockholders: proprietorship")
- Trading on the, 147, 237, 255

"Ex-dividend,"

- Sale of stock at, 146

Existing public service enterprises,

- Investors in, protected, 324
- Occupation of territory by, what constitutes, 315-6
- Protection from competition, entitled to, 309, 314
 - Basis of right, readiness and ability to serve, 309, 314, 316-7
 - Necessary incident of regulation, 310, 314
 - Duty of public to assure, 22
 - Right may be lost, 316
 - Defaults must be serious to cause, 317
 - Indifferent service will warrant, 316-7
 - Merits of competitor to be examined, 317-8 (See "New public service enterprises")

Express powers of corporations, 11

Extension bonds, 185, 188

Extra-long-term bonds, 229

F

Federal incorporation,

- Companies existing under, 9
- General laws for, proposed, 9
- Relation to federal regulation of capitalization, 273

Federal regulation (See "Interstate Commerce Commission")

Federal Trade Commission,

- Creation of, 29
- Powers of, 29-30

Ferry bonds, 188

Finance, corporate, (See "Corporation finance")

Financial condition of corporation,

- Bearing upon proposed capitalization, 303-4
 - Overcapitalization alleged to exist, 294 (See also "Overcapitalization")
- Misrepresentation of, by accounting, 115-6, 298, 301

First lien bonds, 199

First mortgage bonds,

- Definition, 186, 198-9
- Lien of, 185
- Subject to prior liens, 199

Fixed capital,

- Accounting for, bases of, 336-7
 - Capital withdrawn to be credited, 345-8
 - Instructions for, 348
 - Cost as basis of, 77, 119, 337, 340-1 (See also "Cost")
 - Detail to be shown, 343
 - Restatement necessary if original detail insufficient, 343-5
 - Importance of proper, 118, 119-20, 337

Fixed capital—Continued

Accounting for, bases of,—Continued

Operating expenses, charges to, when made, 129-30, 336-7

Correction required if capitalization sought to reimburse, 428

"Secret reserves," created by, 336

Reproduction cost as basis of, 337-9 (See also "Reproduction cost")

Valuations to be used as basis of, 337 (See also "Valuations")

Difficulty of recording, 119, 339-40, 341-3, 435

Additions to, defined, 345

Balance sheet, disposition of, 336

Betterments of, defined, 345

"Book value," 118-120

Capitalization for purposes of, 358 (See also "Intangible capital," and "Tangible capital")

Classification, into landed and non-landed capital, 358

Classification, into tangible and intangible, 358

Consumption of, in productive process, 353

Compared with floating capital, 335, 348

Definition, 335

Depreciating nature of, 348, 349, 353

Floating capital distinguished from, 118, 267, 335

Confusion in accounts may produce overcapitalization, 267

Inadequacy of, entering into depreciation, 350

Intangible (See "Intangible capital")

Landed, 358

Non-landed, 358

Obsolescence of, entering into depreciation, 350

Reimbursing income for moneys expended on, 426 (See also "Reimbursement")

Replacements of, 355 (See also "Replacements")

Sale of, accounting for proceeds, 119

Authorization of commission required, 26

Tangible (See "Tangible capital")

Value of, test, 339

Wear and tear (See "Depreciation," and "Maintenance")

Withdrawals or retirements of, 345-8

Floating capital,

Definition, 335-6

Expense of operation, 336

Fixed capital distinguished from, 118, 335

Confusion may produce overcapitalization, 267

Nature of, 267

Floating debt,

Definition, 443

Funding of (See "Funding operations")

Foreclosure, (See also "Reorganization," and "Remedies of bond-holders")

Basis of right to proceed on, 181

Decree of, 182

Desirable to avoid, because of public policy, 168, 183

Insufficient proceeds, judgment for deficiency, 156

Receivership pending, 181-2

Sale under, 166, 182

Foreign corporations,

Jurisdiction of state over police power as basis, 281-2

Rule as to interstate corporation, 283

Foreign Corporations—Continued

- Limited rights in other states, necessitating subsidiaries, 397-9
- Case of holding companies, 411
- State control made less effective, 398

Forfeiture of stock,

- For non-payment of subscriptions, 43

Founders' shares, 110-11, 366

France,

- Statutory control of overcapitalization, 62

Franchises,

- Classification of, into general and special, 367-8
- Of associates to exist as corporation, 367 (See also "General franchise")
- To occupy streets, etc., 368 (See also "Special franchises")

Full-paid stock,

- Definition, 42
- Status as, of stock sold at discount, 70

Funded debt,

- Amortization of, 237-8 (See also "Amortization of funded debt")
- Certificates of, bonds constitute, 152
- Classification, secured and unsecured, 154-5
- Definition, 149
- Discharge of, provision for payment on maturity, 159
 - Payment of bonds distinguished from discharge of debt, 228
- Issue of, to be authorized by commission, 150
- Matured, classified as unfunded, 149-50
- Redemption of bonds included in (See "Redemption of bonds")
- Refunding of bonds included in (See "Refunding operations")
- Secured, defined, 154
- Security for, 154 (See also "Security for funded debt")
- Unfunded debt distinguished from, 149

Funding operations,

- Capitalization incident to, authority for, 442
 - Purposes must have been proper, 445-6
 - Bond interest, special case of, 446-9
- Distinguished from "refunding operations," 442-3

Future acquired property,

- Covered by existing mortgage, 166-7
 - Attempts to defer lien from attaching, 167
- Situation of individual distinguished from that of corporation, 167

G

General and first mortgage, 200

General franchise,

- Amendment of, right of state to make, 11, 278-9
- Assignment of, 3, 368
- Capitalization of beyond amount of cost not permissible, 360-1
- Cost of, as intangible capital, 360 (See also "Organization expenses")
 - Prohibition against inclusion in capital, Europe, 360
- Definition, 367-8
- Grant of, 1

General franchise—Continued

- Not subject to mortgage, 166
- Not subject to sale, 3, 368
- Property of members and not of corporation, 3, 360, 767
 - Application of, to accounting in European countries, 360
- Revocation of, 3, 9
 - Right of state to cause, 9
- Surrender of, 3

General first mortgage bonds, 200**General laws, incorporation under,**

- Articles of association to be filed, 11
- Corporation created by filing, 11
 - Where filed, 11
- Charter of corporation, what constitutes, 11
- Constitutional provision, New York, in respect of, 11
- Development of method, 10-11

General Mortgage,

- Order of liens, 186, 200
- Purpose of issue, 200

Gold bonds, 187, 235**Good-will, 378****Guarantee,**

- Bonds of subsidiary corporation, 206 (See also "Reinforced security")
- Dividends, by corporation issuing the stock, 101

Guaranteed bonds, 187, 206**Guardianship,**

- As position of commission in relation to investors, 299, 329

H**Holding companies, (See also "Controlling corporations" and "Inter-corporate relationships")**

- Definition, 411
- Financing of, 412
- Jurisdiction of commissions over, 413
- Purpose of organization, 411

I**Impairment of capital,**

- Effect upon right to distribute profits of later period, 123-7
- Restraints on; capital stock reacquired out of surplus profits, etc., 95
 - Dividends to be paid out of profits only, 113-4, 124

Impairment of contracts,

- States prohibited from passing laws causing, 296
 - Effect on corporate charts, 278-9
- Relation to remedy of scaling down outstanding securities, 296

Implied powers of corporation,

- Definition, 11
- Enumeration of, 11-12

Improvement bonds, 186, 188

Improvement or maintenance of service,
Capitalization of expenditures for, 393, 438-40

Incidental powers (See "Implied powers")

Income,

- Account, construction of, 117
- Items included in, 118
- Appropriations for fixed capital investment, 129-30, 336-7
- Accounting, 129
- Capitalization, 426 (See also "Reimbursement")
- From investments (See "Investment income")
- Mortgage, when subject to lien of, 166
- Net corporate, or loss, 117
- Pledged to secure payment of bond interest, 166 (See "Income bonds")

Income bonds,

- Definition, 202, 203
- Interest on, secured by pledge of income, 166
- Security for, second mortgage, 203
- Sold "flat," 221

Incorporation, (See also "Charter")

- Act of, what constitutes, 8
- Date of, under general laws, 11
- Federal, 9
- Individuals alone cannot effect, 3
- Object of, must be legal, 9
- State, general laws for, 10-11
- State, special acts of (See "Special act")

Incorporators,

- Corporations as, 3, 94
- Must be natural persons, 1, 2, 3, 94

Indifference of stockholders,

- Abuses in proxy system due to, 87
- Minority may control because of, 89-90

Indorsed bonds, 206

Indorsement in blank,

- On certificate of stock, effect of, 46-7
- Negotiability effected, 49
- On registered bonds, effect of, 163

Intangible capital,

- Capitalization for acquisition of, 358
- Classification of, 165-6, 358-9
- Contracts rights as, 358, 374
- Definition, 358
- Depreciation of, 359
- Franchise as, 358, 367 (See also "Special franchises")
- Good-will as, 378
- Mortgage on, 165
- Nature of, 358-9
- Organization expenses as, 358, 359
- Patent rights as, 358, 374

Irredeemable bonds,

- Contingent maturity on default of interest, 153
- Limited use of, 228, 229
- Theory of loan capital supporting, 228

Issue,

- "Actual" and "nominal," 38-39
- Of stocks and bonds to be authorized by commission (See "Regulation of stock and bond issues")
- Capital to be secured by, 290
- Penalties for unauthorized issue, 275

J**"Joint-stock associations,**

- Articles of association, 5
- Capital stock of, divided into shares, 5
 - No par value assigned, 6
- Corporations distinguished from, 5
- Definition, 4-5
 - Variety of meanings assigned, 3
- Early form of, 3-4
- Examples of companies now operating as, 5-6
- Liability of members as partners, 5
- Organization under common law or statute, 5
- Place of, in development of business, 12

Junior bonds, 199**L****Land,**

- Value of, apart from operations of railroad, 169

Landed capital, 358**Land-grant bonds, 187-8****Leases,**

- Contracts of, not to be capitalized, 375

Legal investments,

- In relation to fixing proportion of bonds to stock, 266
- Market for unsecured funded debt affected by, 155
- What constitutes, in New York, 266

Legal tender bonds, 187, 236**Liens,**

- Creation of, as security for debt, 155
 - By mortgage or pledge, 155 (See also "Mortgage," and "Pledge")
 - Regulation by state, 280, 285
- Enforcement of, for satisfaction of the debt (See "Foreclosure," and "Remedies of bondholders")
- Multiplicity of, not favored, 199
 - Bond issues intended to unify, 199-201
- Ranking order of, 198-202
 - Bonds, classified on basis of, 186, 198-9
 - Determination of, essential to appraisal of security, 198

Limited liability,

- Attribute of capital stock, 8, 12, 31, 56
- Effect on general creditors, 148
 - No recourse against stockholders, 56
- Joint-stock association, liability of members compared, 5
- Partners, liabilities of, compared, 8, 12, 99
- Par value, measure of, 56

Loan capital,

- Authority for, 148-9 (See also "Borrowing money")
- Definition, 148
- Division into small units (See "Denomination of bonds")
- Integrity of, necessary to be maintained, 56, 148
- Investors in, 154, 210
- Share capital distinguished from, 148
- Stockholders' relation to (See "Trading on the equity")

Long-term bonds, 186, 230-1**Lot,**

- Drawing of bonds by, 234

M**Maintenance of fixed capital,**

- Capital charges not to be included in expenses of, 355
- Classification of charges, 350
- Deferred (See "Depreciation")
- Definition, 349
- Depreciation and, 349
- Even distribution of costs, depreciation accounting to give, 354
- Imperative maintenance, 350-1
- Importance of proper accounting, 350
- Mortgage requirements for adequate provision, 172
- Optional maintenance, 350
 - Results of postponing, 353
- Overstatement, in accounts, 355
- Repairs constituting, distinguished from replacement, 355
 - Definition, 355
- Understatement, in accounts, 355
 - Operating expenses carried in suspense, 355
 - When justifiable, 355

Maintenance or improvement of service,

- Capitalization for, 393, 438-40
- Deficits, capitalization of, distinguished, 440

Majority control,

- General rule in all associations, 89
- Limitation upon, to provide for minority representation, 92
 - Cumulative voting by, 93-4
 - Limiting vote cast by any one stockholder, 93
 - Restricting number of directors voted for by majority, 93
- Number of votes required to authorize acts of corporation, 90
- Proportion of stock required to constitute, 89-90, 394-6
 - Number of stockholders affecting, 89, 90
- Special responsibility of, to minority, 91-2
 - Failure to recognize, reason for minority representation, 93

Market psychology,

- Issue of bonds at discount due to, 217
- Proportion of bonds to stock, effect on, 265-6

Market value of—

- Bonds, attempt to uphold by limiting issue, 191-2
- Causes producing enhancement, 216
- Stock, basis of, 72
- Controlling price of issue, 72-3, 75
- Reflecting adequacy of rates charged by corporation, 73

Materials and supplies,

- Inventory value of, 121

Maturity of bonds,

- Bonds having no, 153
- Effect on classification of debt, 149-50
- Payment upon (See "Payment: bonds matured")

Meeting of stockholders,

- Quorum at, by-laws to prescribe, 90
- Vote of majority present will enact, 90
- Exceptions by statute in specific acts, 90

Membership corporations,

- Classification of, 7
- Definition, 7
- Non-stock corporations as, 6, 7

Merger,

- Capitalization of merging company, extent to which affected, 418
- Contract of, not subject to capitalization, 375
- Definition, 417
- Jurisdiction of commission, 419
- Anti-trust laws, application, 419
- Public policy to control, 332

Minority representation,

- Cumulative voting, 93
- Limiting number of directors elected by majority, 93
- Necessity of providing for, 93
- Special duties owing to, by majority, 91-2

Misdemeanor,

- False statements or representations before commission, 273

Mortgage,

- Authority to execute, 280, 285 (See also "Liens")
- Bond and, defined, 156
- Bond, definition, 188
- Bond essential to existence of, 156, 159
- "Closed," 160
- Conveyance of title, 155-6, 167
- Corporation executes, 156-7 (See also "Trust deed")
- Definition, 155
- Foreclosure of (See "Foreclosure")
- Franchises subject to, 165-6
- Income, when subject to, 166
- Issue of additional bonds, restricted by provisions of, 172-3
- Lien of, deferred, 167
- Enforcement for satisfaction of debt, 180 (See also "Liens")

Mortgage—Continued

- "Open," 160
- "Open-end," 160
- Patent rights subject to, 166
- Power to subject property to, laws governing, 157
 - Limitations of public service corporations, 157
- Property subject to, generally, 165
 - As basis of classifying bond issues, 185-6
 - Effect on characteristics of bonds, 193, 231, 245, 250 (See also "Equipment obligations")
 - Indication of, in bond titles, 185
 - Owned or thereafter acquired, 166-7
 - Personal property, 155, 165
 - Realty alone, 155, 165, 187
 - Personalty usually also included, 155, 165
 - Tangible or intangible, 165-6
- Ranking order of lien classifying: first, second, etc., 186, 199
- Record and filing of, 157, 165
- Validity of, laws of state governing, 157, 280

Municipal aid,

- Extended to railroads, 313
- Prohibited in New York, 313

Municipal corporations, 6, 7

N

Natural monopoly,

- Characteristics of, 19-20
- Public service corporations as, 25

Natural persons,

- Association of, required to organize a corporation, 1, 2, 3, 94
- Powers of, compared with powers of corporations, 1

Negotiable instruments,

- Bonds as, 152, 163-4
- Certificates of stock as, 49
- Characteristics of, 49, 163-4

Net corporate income,

- Definition, 117

Net dividend yield,

- Computation, 220-1
- Definition, 219-20

Net earnings,

- Definition, 123-4

Net interest yield,

- Computation, 221-2
- Definition, 219, 221

New public service enterprises,

- Admission into competition regulated, 22, 26, 308-9
- Existing corporation entitled to protection against competition of, 309, 314 (See also "Existing enterprises")
- Loss of right, 316

New public service enterprises—Continued

Existing corporation entitled to protection against competition of—Continued

Situation of proposed competitor to be considered on affirmative proof, 318

Financial ability to be considered, 318-9

Lower rate proposals not sufficient, 317-8

Popular desire for competition not controlling, 317

Operation in new territory, commission to authorize, 26, 312

Financial resources of applicant to be considered, 318-9

Regulation to prevent bankrupt enterprises, 328

Popular desire not controlling, 313-4, 331

Willingness of investors to engage in, not controlling, 313

Special act, incorporation under, as means of regulating, 23, 309

Territory, contest for, 314-6

Nominal issue, 39**Nominative shares, 50****Non-cumulative preferred stock,**

Definition, 103

Interest of common stock may adversely affect, 104

Non-landed capital,

Definition, 358

Non-participating preferred stock,

Definition, 101

Non-stock corporations, 6, 7**Notes, corporate,**

Bonds, compared with, 152

Definition, 152, 202

Demand for, as incentive to use of, 233

Maturity in less than year, issue not regulated, 150, 232, 443

Purpose of exemption, 443

Renewals, limitations on, 150, 232, 444

Longer term bonds or notes, (See "Funding operations")

Use of, to avoid jurisdiction of commission, 232, 443

Attempts to be discouraged, 443-4

Responsibility of commission for, 232, 444

Maturity in more than year, issue regulated, 27 (See also "Bonds," "Regulation of stock and bond issues")

Purpose of short-term issues, temporary aid, 231

Tentative financing, pending market improvement, 231-2

Conditions governing economical use of, 232

Short-term bonds and, definitions, 186

Unsecured by lien on property, usual condition, 152, 202

Validity of laws of state governing, 149

O**"Open-end" mortgage, 160****"Open" mortgage, 160****Operating expenses,**

Capitalization to provide for (See "Maintenance or improvement of service," and "Working capital")

"In general grossly offensive," 439

Manipulation of, affecting surplus, 121

Suspension of, 122

Optional bonds, 186, 233, 234

Organization expenses,

- Capital charge, 360
 - Excluded from, by German and Swiss laws, 360
- Capitalization of, 359, 367
 - Valuations other than cost not allowed as basis, 361
- Intangible capital included in, 358-9
- Items included in, generally, 359
 - Corporate organization expenses, 361-2
 - Financing expenses, 362
 - Bond issue, for capitalization purposes, 364
 - Accounting for (See "Discount: bonds, suffered on issue of")
 - Stock issue, 362
 - Promoters' fees, 364 (See also "Promoters' fees")
 - Taxes paid on organization, 361

Overcapitalization,

- Causes producing, 267, 303-4
- Circumstances at time of issue to be known before condemning, 301-2, 305-7
- Definition, 58, 296-7
 - Dissimilarity of meanings, 297
- Effect on additional capitalization, 294-5
 - Need not be a bar to, 301 (See also subhead below, "Remedies")
- Inflation of credit supposed to be produced by, 57
 - Different results of stock or bond issues, 297-8
- Misstatement of accounts, incident of, 298, 301
- Rates for service, relation to, 64, 65
- Remedies, omission of par value, 81
 - Regulation of accounts as, 299
 - Scaling down securities, 295-6, 299

Overlying bonds, 199

P

Participating preferred stock,

- Definition, 101
- Rate of dividends, 101-2
- Terms of participation, 101-2

Partnerships,

- Alleged relation between public service corporations and public, 21-2
- Corporations and, distinguished, 12
- Interests of members in, 96
- Joint-stock associations as, 4, 5, 6
- Liability of members, 8, 12, 96
 - Compared with that of stockholders, 8, 12
 - Similar liability in joint-stock associations, 5
- Limitations of, a factor in development of corporations, 3, 12
- Place of, in development of business, 12
- Stockholders, relationship between themselves that of, 96, 99-100

Part-paid stock,

- Agreement of subscription under, 42, 43, 44
- Issue for insufficient consideration, effect, 57, 71
 - Liability of holders, 42, 71 (See also "Watered stock")
 - New York rule, 57

Par value,

- Amount of, 36
- Balance sheet, capital stock appearing at, 55
- Capital stock to be issued at, general rule, 54
 - To avoid inflation, 57
- Corporate financial responsibility, measured by, 56
- Issue of stock at less than, 34-5
 - Forfeiture of charter for, 57
 - Liability of purchaser, 56
 - New York rule, 57
- Misconception of meaning of, 72
- Necessity of, stock preferred as to assets, 55
- Price of issue to be, general rules, 34, 41, 54
 - Deviations from, 34 (See also "Discount: stock sold at," and "Premium: stock sold at")
- Purpose of assigning a, 32, 36, 81
- Real value distinguished from, 64-5, 72, 76-8, 298
- Record of stockholders' investment, 55
- Relation to increase in amount of proprietorship, 55
- Shares without, 36, 78-83 (See also "Shares without par value")
- Significance of, 54-8
- Stockholders' contribution to capital, measured in terms of, 41, 55
- Stockholders' equity, reference to, 54
- Stockholders' liability limited to, 57
- Trust fund theory, application, 55-6
- Watered stock sold for less than, 58 (See also "Watered stock")

Patent rights,

- Accounting for cost of, 374
- Capitalization of, 374
- Mortgage, subject to lien of, 166

Payment,

- Bond interest (See "Interest")
- Bonds matured, amount of face value, 152-3
 - Deduction for taxes, without, 160
 - Medium of, classification according to, 187
 - Gold coin, 159, 235
 - Legal tender and currency, 236
 - Purchasing power of money in relation to, 236
 - Silver, 236
- Bonds prior to maturity (See "Redemption of bonds")
- Dividends (See "Dividends")

Permanent debt (See "Funded debt")**Personal enterprises,**

- Corporate project as, of stockholders, 2, 31
- Place in development of business, 12

Personal interest,

- Of stockholder, affecting relations with corporation, 42
 - Elimination of, in valuing property sold to corporation, 62-3
 - Necessary to safeguard corporate welfare, 87

Personal property,

- Bonds as, 206
- Bonds secured by, classification, 186, 188 (See also "Collateral bonds," and "Equipment obligations")

Personal property—Continued

- Chattel mortgage on, 155, 165
- Pledge of, 155
- Real estate mortgage, when included in, 165
- Real property distinguished from, 165
- Shares of stock as, 47, 51
- What constitutes, 165

Physical valuation of railroads,

- Conducted by Interstate Commerce Commission, 252, 270, 414, 433-5
- Limiting capitalization to, 69, 151, 296, 302

Plain bonds, 202**Plant (See "Fixed capital")****Pledge,**

- Chattel mortgage distinguished from, 155
- Definition, 155
- Of securities deposited as collateral, 179

Police power of state,

- In regulation of foreign corporations, 26, 278, 282

Popular desire,

- Commission not to be influenced by in regulation, 282, 331

Powers of corporation,

- Definition, 11
- Express, 11
- General, 1, 8, 11
- Implied, 11-12

Preferred stock,

- Assets of corporation upon dissolution, equal rights of shares, 98
- Preference given by agreement on statute, 96, 99
 - Shares required to carry par value if so preferred, 55, 80, 99
 - Terms of, 99
- Authority for creation of (See "Capital stock: classification")
- Callable, 108, 221
- Classes of, first, second, etc., 98
- Convertible, 107
- Cumulative, 103
- Debt of corporation, not a, 99, 100
 - Special classes resembling, 100
- Definition, 98
- Divergent interests introduced because of, 105
- Diversion of dividends, remedy of stockholders, 103
- Dividends,
 - Attribute of preference in, 101
 - Participation in profits beyond preferred rate, 101-2
 - Past-due dividends, claim on, 103
 - Rates of, 101, 102
 - Terms of preference, 101
- Financing by bonds or, 98, 102-3, 107
- Lien of, none granted, 99
 - Special classes purporting to carry, 100
- Non-cumulative, 103
- Non-participating, 101
- Participating, 101

Preferred stock—Continued

- Preferences, conditions described in charter or by-laws, 37, 97
 - Kinds of, 96-7
 - Order of, 98
- Priority over subsequent mortgages, Maryland special stock, 100
- Redeemable, 100, 108, 221
- Sole outstanding issue, 97
- Voting rights,
 - Limitation upon in favor of common stock, 106-7
 - Reason for, 107
 - Waiver conditional, 106-7
 - Preference in, not necessary incident of, 105
 - Common stockholders relinquish in favor of, 105
 - Reason for, 105-6
 - Nature of preferences, 105-6

Premium,

- Bonds, realized on sale of,
 - Accounting for, 224-6
 - Interest to be paid offset by, 216
- Bonds sold at, considerations governing, 216
- Stock, realized on sale of,
 - Accounting for, 75-6
 - Permanent reserve, 74, 75
 - Significance of, 74
- Stock sold at, considerations governing, 74

Price of issue,

- Commissions to prescribe minimum,
 - Bonds, 218, 364
 - Stock, 70-1
- Market values in relation to, 70-1, 72-3, 75
 - Competition of capital affecting, 214
- Regulation of, experiments of Massachusetts, 70-1

Prior lien,

- Bonds, 199
- Ranking order of lien, 186, 198

Private corporations,

- Classification, 6, 7
- Definition, 6
 - Qualified in comparison with "public service," 14
- Regulation, extent of, compared, 267

Private interest (See "Personal interest")**Proceeds of capitalization,**

- Assurance of proper use important, 178, 267, 274
- Certification on bonds purporting to assure propriety of, 175-6
- Commission to direct use of, 27, 178, 286
 - Regulation of capitalization most effective in this respect, 274, 427
- Place of expenditure as affecting state jurisdiction (See "Regulation of stock and bond issues: jurisdiction of commissions")

Profit, (See also "Corporate surplus or deficit")

- Applicable to payment of dividends, how determined, 123
 - Definition, English courts, 124-6
 - Definition, United States courts, 123-4
- Current, divisibility of in face of impaired capital, 123-7
- Part of corporate assets until dividend declared, 32, 128-9

Promoters' fees,

- Capital charge as part of organization expenses, 366
- Abuses of capitalization through, 364
- Legitimate use of, 364-5
- Proper amount, 365
 - Benefit to community a consideration, 366
 - Examination by commission, 366
 - Should be sufficient to encourage pioneering, 365-7

Property,

- Classification into real and personal, 165 (See also "Personal property" and "Real property")
- Lien upon for security of debt, 154 (See also "Mortgage" and "Security for funded debt")
- Nature of, effect on term of bonds, 193, 231, 245, 250
- Of public service corporations, value of, separate from operations, 168-9

Property dividends, 145-6

Proportion between stocks and bonds,

- Authority of commission to prescribe, considered, 259-60
- Bonds, undue proportion of in early finance, 251-2
 - Conditions producing, 254
 - Evil results of having, 252-4
 - Railroad stocks alleged to represent "water" because of, 252
- Consideration controlling, general, 260
- Difficulties, general, 251
- Principles governing proper, 262
 - Earnings affecting, 261, 262, 263-5
 - Corporate control affecting, 262-3
 - Marketability affecting, 265
- Railroad capitalization, present proportion, 252
- Regulation of, by statute, 292-4
 - Restriction withdrawn as to public service corporations—California, 260-1
- Substantial stockholders' investment to support loans, 252-4, 255, 259
- Tendency to increase proportion of stock, 254

Proprietary corporation,

- Definition, 395
- Financing of, 399, 405 (See also "Controlling corporation")

Proxy, right to vote by,

- Abuses of, 85-6, 87
 - Indifference of stockholders responsible for, 87, 90
- Definition, 87
- Illegal exercise of, 85
- Nature of, 87
- Permission of law required in charter or statute, 87
- Sale of, prohibited, 85

Public,

- Corporations, definition, 6
 - Municipal corporations, 7
- Duty of, toward public service corporations, 21-2
 - Attempts to perform through regulation, 23 (See also "Regulation")
- Faith and credit, responsibility of commissions, 332
- Interest, charging private enterprises with, 14-5, 18-20, 22
 - Protection of, by commissions, 332-4, 402-3
- Policy, affecting authorizations of commission, 332-4
- Records, reports filed with commissions, 27
- Regulation, (See "Regulation")

Publicity,

Aid in controlling capitalization, 269, 274, 275

Necessity for,

To protect creditors, 64

To protect investors, 64-5

To protect stockholders, 78

To prevent stock-watering, 61

Public service commissions,

Authority to regulate, 26-8

Accounts and accounting (See "Accounting," and "Accounts")

Capitalization (See "Capitalization," "Regulation of stock and bond issues")

Competition (See "Competition")

Intercompany relationships (See "Intercompany relationships")

Operations, 27, 274, 323

Organization (See "New public service enterprises")

Rates (See "Rates")

Reorganization (See "Reorganization")

Corporations under jurisdiction of, 17-8, 25-6, 276

Status of foreign and interstate commerce corporations, 282-3

Creation of, 25, 274

Organization in two districts, New York, 26 (note)

Paramount duty of, 304-7

Powers of, enumerated, 26-8

Regulation by, purpose of providing for, 23, 25, 274, 288-9 (See also "Regulation")

To be positive, constructive, and permissive, 301

Scope of authority granted to, 288

Task of, generally, 28, 286

Co-operative effort with corporations required, 288-9

Public service corporations, (See also "Public service undertakings")

Accounts of (See "Accounts," and "Accounting")

Capitalization of (See "Capitalization," and "Regulation of stock and bond issues")

Characteristics of, 15, 17

Classes of, 19

Common carriers as, 17

Competition between, regulated (See "Competition")

Definition, 14 (See also "Public service undertakings")

Intercompany relationships between, regulated (See "Intercompany relationships")

Operation of, commission to authorize new, 27, 312 (See also "New public service enterprises")

Continuance of, to be assured, 19, 20, 157, 170

Affecting corporation's power to mortgage properties, 157

Security for debt affected by, 170, 183

Control of, as aid in regulating capitalization, 269, 270, 274

In relation to rate regulation, 323

Paramount duty of commission to maintain continuance of, 289, 304-5

Regulated by commission, 27, 274

Popular to attack, 331

Private corporations, distinguished from, 14

Rates (See "Rates")

Regulation of, basis for, 19

Relation to public, 20-1

Assumed,

Agency, 21, 22

Partnership, 21-2

Trusteeship, 21, 23

Reciprocal duties, 22

Public service undertakings, (See also "Public service corporations")

Element of public interest controlling, 14 (See "Public interest")

Enumeration of, 17

Natural monopoly, characteristic, 19-20, 25

Private undertakings distinguished from, 14

Special duties of those engaging in, 15, 20

Case of common carriers, 15-6

Development of laws governing, 14-5

Discrimination in rates or service prohibited, 13

What constitute, 14, 20

Common carriage, test, 15-6

Declaration of California Constitution, 18

Governmental function, test, 17-8, 21

Relation to needs of community, 18-9

Purchased-line bonds, 186, 188

Purchase money mortgage bonds, 202

Purchase of plant,

Accounting upon, 391-2

Commission's supervision over transfers, 390

Contract for, review by commission, 391

Cost of, capitalization for, 390

R

Railroad commissions (See "Public service commissions")

Railroads,

As common carriers and public service undertakings, 17

Public highways, 21

Regulation of, 23-5

Absence of, disastrous, 24

Necessity for, 25

Stock of, held by other railroad corporations, 397

Rates,

Adequate, duty of public to assure, 22, 73, 323

Basis of, confusion in, 64, 268

Capitalization and, 268, 320-3

If commission controls both, 320-1

Statement of Massachusetts commission, 321-3

Competitive railroad, 268

Early regulation by charter provisions, 23

Experimental nature of, 73, 307

Reasonable, what constitute, 319-20, 326

Regulation of, by commission, 27, 319

Demand for, because of monopolistic enterprise, 319

Relation to control of capitalization, 269, 270, 274

Rate wars,

Causes and evil effects of, 24, 309 (See "Competition")

Regulation designed to prevent (See "Certificate of public convenience and necessity")

Reacquired bonds,

Status of, 247, 249

Reacquired stock,

Acquisition of, how effected, 95

Dormant, not sharing in dividends or control, 95

Real estate, (See also "Real property")

Bonds, defined, 187

Mortgage, 165, 187

Bonds, defined, 187

Power of corporation to buy, hold, and sell, 11-2

Real property,

Bonds secured by mortgage on, 185

Classification of, 185-6, 187-8

Mortgage on, 155, 165 (See also "Mortgage")

What constitutes, 165

Receiver's certificates,

Issue of, 205

Prior lien bonds after reorganization, 199

Security for, 205

Redeemable bonds,

Definition, 186, 233

Disadvantages to holders, 234

Premium paid to compensate for, 234

Redeemable preferred stock,

Callable same as, 108

Computation of yield, 221

Definition, 100, 108

Premium paid on, 108

Redemption of bonds,

Prior to maturity (See also "Payment: bonds matured")

Methods, classification of bonds according to, 186, 233-4

Process of amortization (See "Amortization of: funded debt")

Reasons for, 233

Refunding first mortgage, 201**Refunding mortgage,**

Bonds, 201

First, 201

First and, 201

Order of lien, 186

Refunding operations,

Capitalization incident to, authority for, 286, 442, 450

Conditions producing necessity of, 450-1

Cost of discharging or refunding, 451, 452-3

Definition, 449

Distinguished from funding operations, 442-3

Presumption of proper original issue, 451

Registered bonds,

Definition, 162

Denomination of, 154, 162

Indorsement in blank, effect, 162

Interchangeable with coupon bonds, 162

Interest paid to owner direct, 162

Preference for, because of, 164

Registered bonds—Continued

- Owner's name recorded, 162
- Payee, description of, 161, 162
- Principal and interest registered, 162
- Principal only registered, when, 163 (See "Registered coupon bonds")
- Safety in keeping, preference because of, 164
- Transfer, writing required, 162
- Difficulty of, a disadvantage, 164

Registered coupon bonds,

- Form of a coupon bond, 163
- Indorsement to bearer, 163
- Interest collected by coupon, 163
- Principal only registered, 163

Registered stock, 45-6

Registrar,

- Countersignature on stock certificates, 45

Regulation,

- By commissions, based on control of enterprises charged with public interest, 19
- Development of, 23-5
- Purpose of, 23
- Reciprocal duties of public recognized in, 22, 23
- Requirements of public policy, 330
- To be positive, constructive, and permissive, 301
- Charter provisions intended to secure, 23
- Development, early exercise over common carriers, 23-5
- Extension of (See "Public service commissions")
- Introduced to correct evils of unrestrained competition, 24 (See also "Competition")

Regulation of stock and bond issues by state commissions,

- Authorization of commission required, 27, 274, 289
- Great latitude allowed to commissions, 274, 290-1, 294
- Limitations on discretionary power if statute is complied with, 287, 292-4
- Capital to be secured by issue, 290
- Collateral aspects of capitalization to be considered, 308
- So also incidents of capitalization, 290-2
- Considerations of public policy, 330, 332
- Co-operative effect of commission necessary, 288
- Demand for, 267-8
- Direct powers of commission, 268
- Effectiveness of, 274, 275
- Examination to be made by commission, what to include, 291-2
- Indirect powers of commission, 274-5
- Jurisdiction of commissions in respect of, generally, 275, 283-4
- Domestic corporations, 276
- Effect if proceeds are to be spent outside state, 276-81
- Maryland, decision of court, 277-8, 279, 281
- Nature of securities, affecting jurisdiction, 279-80
- Foreign corporations, 281-5
- Effect if proceeds are to be used within state, 281, 285
- Nature of securities, affecting jurisdiction, 283-5
- Price of issue to be fixed, 218-9
- Public confidence in, effect on securities market, 254-5
- Purpose of providing for, 289, 427, 445

Regulation of stock and bond issues by state commissions—Continued

Purposes for which authorization may be had, 286-8 (See detail under "Capitalization")

Regulation to be constructive, 301

Requisites for authorization, 290

Probability of adequate return upon, 292, 327-8

Reasonableness of amount, 286, 289, 291

Responsibility of commission, 325, 330

Right of public to rely on findings, 326-7

State not a guarantor of authorized issues, 322, 325-6

Uniformity in laws and practices required, 275

Conflicts limit efficiency of state regulation, 270-1, 281

Reimbursement of income or surplus,

Capitalization for, of moneys expended on fixed capital,

Amount of moneys expended, accounts to disclose, 429-33

Depreciation accrued to be deducted, 432

Investment of special funds to be excluded, 430

Matters includible in, 438

Valuation or appraisal, if records cannot disclose, 433, 436

Reproduction cost not applicable, 436

Application for authority to be made within period limited, 427, 428

Authority for capitalization, 286, 426-7

Basis of right, 427

Expenditure for proper purposes to be shown, 431

Maintenance and replacements not proper purposes, 430-1

Right of corporation for authorization if statute is satisfied, 437-8

Stockholders' interest, how affected through reimbursement, 428-9

Reinforced security,

Guarantee by third party, 206

Careful examination necessary to determine security, 206

Indication by indorsement on bonds, 206

No lien on property of guarantor, 206

Remedies of bondholders,

Enforcement of, on default, 180

Postponement of effective date, 180-1

Through trustee, 159, 181

Bondholders may direct action of trustee, 181

On default of trustee bondholders may act, 174, 181

Foreclosure (See "Foreclosure")

Possession of property assumed under power of mortgage, 181

Restriction placed on, by public policy, 168, 170, 183

Sale of property under power of mortgage, 181

Reorganization,

Capitalization increased, usual incident of, 255, 422

Compromise usually representing a, 184

Favored by law to avoid foreclosure, 183

Different meanings of term, 422-3

Fixed charges, purposes to reduce, 422

Jurisdiction of commission, 28, 423-4

Method following foreclosure, 183, 423

Organization of new company, 183-4

Plan prearranged, 423

Value of property, to control capitalization, 424

Difficult to determine, 425

New York court decisions relating to, 424-5

Statute amending rule, 423-4

Replacements,

Definition, 355-6

Expenditures for, accounting of, 356-7

Proper accounting important, 118

Capitalization abused by improper accounting, 303-4

Repairs and maintenance distinguished, 355

Reports,

Of corporations to public service commissions, 27

Public records, 27

Publication of, effect on regulation of capitalization, 269

Reproduction cost,

Application to public service properties limited, 338-9

Attempted use as basis of fixed capital accounting, 337-8

Use in determining sum of capital expenditures from income, 436

Right of way,

Value of, apart from operation, 168-9

S**Sale,**

Of plants devoted to public; authority required for, 26, 390

"Anti-trust" laws and general public policy to control authorization, 322

Scrip,

Convertible, definition, 134

Definition, 133

Dividends paid in, 133-4

Participation in dividends, 134

Possible use to evade statutory dividend prohibitions, 135

Second mortgage bonds, 199**"Secret reserve,"**

Created by charging capital expenditures to operating expenses, 336 (See also

"Income: appropriations from, for investment in fixed capital")

Secured funded debt,

Classification of, by nature of property, 185-6

Credit, bonds resting upon, not constituting, 154

Definition, 154, 185

Security for funded debt,

Classification of bonds on basis of, 185, 187

Control, share in, given to bondholders to increase, 170-1 (See also "Bondholders: control over acts of corporation")

Earnings, ability to maintain, constituting essence of, 170

Equal rights of bondholders in respect of, 158-9

Increase in, effected by serial maturity or sinking fund, 243 (See also "Equipment obligations," "Serial maturity," and "Sinking fund")

Intangible, consisting of debtor's credit, 154

Interest rate affected by, 211, 216

Investors' desire for, facilitating corporate borrowing, 147, 154

Lien, creation for purposes of, 155

Maintenance of property constituting, provisions for, 171-2

Mortgage, careful examination of provisions necessary to estimate, 171

Principal and interest equally protected, 159-60

Interest alone secured by pledge of income, 166 (See also "Income bonds")

Security for funded debt—Continued

Reinforced, 187, 206 (See also "Guaranteed bonds" and "Sinking fund")

Resort to, in case of default (See "Remedies of bondholders")

Value of, and amount of debt, 167

What constitutes, in public service plants, 168-70 (See also "Value of public service plants")

What constitutes, 154, 171, 250

Senior bonds, 199**Serial bonds, 186, 239 (See also "Serial maturity")****Serial maturity,**

Amortization of debt, method, 237, 245

Bond values affected by variations in terms of bonds, 239

Equipment obligations subject to, 193, 243

Equity of bondholder increased by, 193, 243-4

Installments equal in amount of maturing principal, 245

Equal instalment, viz., principal plus interest, 246

Failure to pay any, matures entire series, 245

Reflecting nature of property by which secured or for which used, 193, 245

Relation to accruing depreciation, 193, 243-4

Sinking fund compared with, in respect of amortization, 243, 245

Share capital, 148**Shares of capital stock (See also "Stock" and "Subscriptions")**

As "goods, wares, and merchandise" within Statute of Frauds, 40

As personal property, 47

Purposes of taxation, 51

Definition, 32

Limitations upon number to be individually owned, 35

Meaning of "shares" in usage of England, 111, 204

Par value of (See "Par value," and "Shares without par value")

Representation of, 34

"Shareholders" (See "Stockholders")

Taxation of, 51-53

Transferability of (See "Transfer")

Value of, for purposes of taxation, 52

Shares without par value,

Accounting record of price realized on issue, 82

Collateral requisites for successful use, 83

Experimental stage, adoption of method in, 83

Fractional interest in corporation representing, 78

New York statute in respect of, 80-1

Par value, shares having, compared with, 36, 81-3

Preferred stock, when not applicable to, 55, 80, 99

Purpose in using, 78-9

Remedy for evils of overcapitalization, intended to be, 81

Shares of joint-stock associations, compared, 81, 82

Short-term bonds (See "Notes")**Silver bonds, 236****Sinking fund,**

Amortization of debt, method of, 237

Equalizing burden of, 246

Serial maturity as another method of, compared, 245

Appropriations to, source of, 241-2

Sinking fund—Continued

- Definition, 239-40
- Desirability of, for supposed bondholders' assurance, 243, 249-50
- Equity of bondholders increased by, 243
- Increments of, disposition made thereof, 240
- Operation of, and accounting for, 240-2
- Reinforcing security of debt by, 187, 206
 - Of limited utility, 249-50
- Relation to depreciation, 243-4

Sinking fund bonds, 187, 206

Sinking fund investments,

- Cash funds, 246
- Company's plant, 248-9
- Company's securities, 246-7
- Control over, 249
- Earnings of, disposition, 240
- Securities of other companies, 247-8
- Trustee, relation to, 249

Solvency of corporation,

- Balance sheet measuring, 118, 342
- Facts concerning, hidden by defective accounting, 116

Special act, incorporation under,

- Abuses introduced into method, 10
- Advantages which accrued from, 23, 309
- History of, 9-11
- Prohibition against, New York constitution, 10-11
- Recitals of statute, 10

Special franchises,

- Accounting for costs of acquisition, 392-3
- Annual costs imposed by, not subject to capitalization, 370-1
- As property, 367, 368
- Cost of,
 - Chargeable to capital, 368
 - Subject to capitalization, 369, 371
- Definition, 367
- Exercise of powers under, to be authorized by commission, 26
- Free service given under terms of,
 - Accounting for costs of, 373
 - Constituting discrimination, 369
- General franchise, distinguished from, 367-8
- Lease, transfer or other agreement concerning ownership to be authorized by commission, 26, 371
- Mortgage of corporate realty including, 165-6
- Purchase or assignment, 371-2
- Sale of by municipality, method criticized, 369
- Value for capitalization purposes not to exceed cost, 369

Special privilege,

- Right to issue stock, bonds, etc., declared to be a, 283
- Comment, 283-4
- "Special franchise," compared as to meaning, 284

Special stock, 110

Specific powers of corporation, 11

State,

- Incorporation of private companies (See "General laws," and Special act")
- Jurisdiction over domestic corporation, 276, 284
 - Capitalization of (See "Capitalization: state jurisdiction of")
- Jurisdiction over foreign corporations, 282
 - Capitalization of (See "Capitalization: state jurisdiction of")
 - Police power, basis of, 278, 282
- Jurisdiction over interstate commerce corporations, 283
- Public service commissions (See "Public service commissions")
- Public service corporations, regulation of (See "Regulation")
- Real property within its borders, right to control, 280, 285

Statute of frauds,

- Agreements for purchase of shares, 39, 40

Statutory restraints on watering stock,

- Aim of statutes, 61-2
- English law, 63-4 (See also "England: Prospectus Act of")
- French law, 62
- German law, 62-3
- Public service commission laws, 65-6

Stock (See also "Capital stock," "Shares," and "Subscriptions")

- Bonds and, compared, 152
- Book, 40
 - Closing of, prior to payment of dividends, 146
 - Inspection of, by stockholders and judgment creditors, 40
- Certificates (See "Certificates of capital stock")
- Corporation investing in its own (See "Acquisition: of stock of own issue")
- Dividend paid in (See "Stock dividend")
- Issue of, what constitutes, 38-40
- Market for, compared with bond market, 254
 - Effect on determining proportion of bonds to stock, 265
- New, offered to stockholders, 263
- Ownership of, for purposes of control (See "Controlling corporation")
- Right to issue, declared to be a "special privilege," 284
- Sale of, commissions paid on, 71
- "Shares" distinguished from, in usage of England, 111, 204
- Subscriptions to shares of (See "Subscriptions")

Stock corporations,

- Advantages of organizing into, 7-8, 31-2
- Incidents of ownership allocated, 12-3
- Partnership, compared with, 12 (See also "Stockholders: limited liability")
- Civil corporations as, 6, 7
- Definition, 7-8
- Finances of (See "Corporation finance")
- Interest of members in capital, control, and profits, 8, 31
 - Agreements to classify stock modifying, 96
 - Par value of shares adopted for ease in division of, 32
- Private corporations, classification of including, 6-7
- Purpose in organizing, 7, 31
 - Objects to be in accord with public policy, 9
- Stockholders' relation to, 7, 8, 31

Stock dividend,

- Authorization for, where found, 139-40
- Definition, 138
- Distribution of, effect on stockholders' interest, 139-9

Stock dividend—Continued

- New York Central distribution of "interest certificates," 141-5
- Purpose of, to divide profits invested in capital, 138
- Statutory restrictions on declaration of, 139
 - Indirect method, 140-1
- "Watering stock," alleged means of, 58

Stockholders,

- Acting for corporation; appointment as officer or employee necessary, 7
- Bondholders distinguished from, 210-1
- Control over corporation, inherent right to share in, 84, 104, 171, 394
 - Apportionment of, between classes of stockholders, 84, 96, 104
 - Divergent interest introduced, 105
 - Proportionate amount of shares in each class affecting, 96, 106
- Direct, what constitutes, 85
- Exercised by majority, 394 (See "Majority control")
- Indirect, over management and property of corporation, 84-5
- Limitations upon, in favor of bondholders, 84
- Preference in, given to one class of stock, 104
 - As sole basis for classifying stock, 98
 - Classification of preferences, 105-6 (See also "Control," and "Preferred stock: voting rights")
 - Specific limitations by agreement, 395
- Creditors distinguished from, 99-100
- Interest in control, capital, and profits of corporation, 8, 31
 - Agreements to classify stock modifying, 96
 - Title to assets is equitable, not legal, 130
 - Undivided interest in assets of corporation, 31, 129
- Limited liability of, 8, 12, 31, 56
- Meetings of, basis of representation at, 90
 - Proportion of voting rights required to authorize, 90
- Number of, may be limited by restricting ownership of shares, 35
- Of record, definition, 46
 - Rights of, 46-7, 146
- Proprietors of corporate enterprise, 2, 31, 33-4, 36, 210
 - Must have contributed to capital of corporation, 40
- Proprietorship, value of, 54, 72, 76
 - Difficulty of ascertaining from accounts, 77
- Proprietary interest indicated by shares holdings, 32, 35
 - Affected by class of stock held, 96
- Public service corporations as, 87, 94-5, 396
- Qualifications of, generally, 94
 - Restrictions on public service corporations, 27, 94-5, 396
 - Stock corporations as, 94
- Relationship of, 32, 36-7, 38, 43
- Title to and remedies for undivided profits, 128-131
 - For dividends declared and due, 130
- Traders on the equity as (See "Trading on the equity")

Straight bonds, 186, 239

Subscriptions to shares of stock,

- Agreement for, 43
 - After incorporation, 45
 - Before incorporation, 44-5
 - Of subscribers to certificate of incorporations, 44
- Forfeiture of stock for non-payment of, 43

Subscriptions to shares of stock—Continued

Liability for payments on call of directors, distinguished from debt of promissory note, 43-4

Receipt for payments, effect of, 38

Remedy of corporation for failure to pay, 43, 44

Subsidiary companies (See "Controlling corporations")**Surplus,**

Appropriations from, for investment in capital, 129 (See also "Income: appropriations")

Accounting for, 123, 129

Capitalization of, 426 (See "Reimbursement")

"Book" and real, distinguished, 118-120, 123

Definition, 115, 118 (See also "Corporate surplus or deficit account")

Dividends must be paid out of, 113

Amount applicable, how determined, 115, 123 (See also "Profit")

Unwise to apportion entire amount, 127

Importance of accounting in determination of, 116, 119

Investments in securities of other companies or in outside properties to be made out of, 414

Manipulation of, 121-2

System Corporations,

Affiliated corporations as, 395 (See also "Intercorporate relationships")

Financial transactions between, to appear distinctly on balance sheet, 121 (See also "Controlling corporations")

T**Tangible capital,**

Capitalization for acquisition of, 379 (See also "Construction," and "Purchase of plant")

Definition, 338

Taxation of,

Bonds, as personal property, 206

Exemption of governmental and municipal bonds, 208

Levy upon income, 208

Tax-free covenants, construction of, 160, 208-9

Levy upon principal, 207

Unfair to tax both principal and income, 208

State policy in relation to, differences in, 207

Corporate properties and enterprises, 51

Shares and capital stock, 51

Authorized capital stock, tax levied upon organization, 53

Capital stock, tax levied against corporation, 51-2

Double taxation, danger of, 52

Shares as personal property, 51-3

State policy in relation to, differences in, 52

Temporary bonds, 160**Temporary stock receipts, 38****Terminal bonds, 186, 188****Term of bonds,**

Classification on basis of, 186

Determined by nature of security, 193, 231, 245, 250

Term of bonds—Continued

- Effect on value of bonds, 230
- Factor in computation of investment yield, 221
- Market conditions at time of issue controlling, 231, 232

Texas,

- Experience of, in limiting capitalization to reasonable value of property, 69, 302

"Trading on the equity,"

- Advantage to stockholders, 147, 237
- Consideration inducing stockholders to give up, 255
- Definition, 147

Traffic,

- Failure of, effect on value of a railroad, 169

Transfer,

- Agent, appointment of, 45
 - Countersignature, when required, 45
 - Duties, of 46
- Bonds,
 - Payable to bearer, by delivery, 163
 - Registered, writing required, 162
 - Exception of registered coupon bonds indorsed to bearer, 163
- Shares of capital stock,
 - Assignment in writing required, 46
 - Form printed on certificate, 37, 46
 - Indorsement in blank, effect of, 46, 50
 - Record on books, 46, 47, 146
 - Ledger for 48
 - Prohibition affecting public service corporations, 27, 47-8
 - Transferee entitled to demand, 47
- Right of transfer,
 - Reasonable restrictions proper, 47
 - Suspension of, in French law, applying to vendor's shares, 62
- Tax, 48

Trust deed,

- Authority for execution of, 158
- Bond agreement, incorporated in, 159, 162
- Bondholders, beneficiaries of, 158
- Bonds, amount of issue provided for in, 160
- Bonds, form of described in, 162
- Circumstances necessitating use of, 156-7
- Form of, 157
- Parties to execution of, 158
- Trustee (See "Trustee")

Trustee,

- Acts of, binding on bondholders, 174
- Appointment of, under corporate deed of trust, 173
- Bondholders' rights and remedies exercised through, 174
- Care of collateral pledged, 174, 179-80
- Certificate of, indorsed on bonds, 161 (See also "Certification")
- Duties of, 173, 175
- Duty to proceed against property, when obligatory, 159
- Failure to act, bondholders may act, 174
- Injunction to restrain acts of, when available, 173
- Legal title conveyed to, in trust for bondholders, 156, 158

Trustee—Continued

- Liability of, limited, 173, 174, 177
- Majority stockholders as, to minority, 91
- Public service corporation considered as, 21
- Relation to bondholders, 173
- Relation to corporation, 174, 249
- Removal of, 173
- To examine security, 174-5
- Trust companies as, 173-174

Trust fund theory, 55-6**U****Unamortized debt discount and expense,**

- Text of account, 223-4

Underlying bonds, 199**Unextinguished discount on capital stock,**

- Text of account, 75-6

Unextinguished premium on outstanding funded debt,

- Text of account, 225-6

Unfunded debt,

- Definition, 149
- Financing by (See "Notes")

Uniform stock transfer act,

- Warranties of transferor of stock described, 50-1

Uniform systems of accounts,

- Authority of commission to prescribe, 27
- Purpose of requiring, 116

Unifying mortgage bonds, 201**Unsecured funded debt,**

- Classification of, 202-3
- Contingent security, 203
- Credit, debts resting upon constitute, 154
- Definition, 202
- Desirability of, not measured by lack of tangible security, 154
- Limited market for, 155
- Receivers' certificates as, 205

Usury laws

- Not operative on corporations, 214

V**Valuations,**

- Basis of accounting, 341-2, 435
- For purposes of estimating overcapitalization, 302
- Misapprehension concerning nature of, 433
- Physical, of railroad property, 252, 270, 414, 433-5
- Qualifications with which results must be stated, 434, 435
- "Reproduction cost" basis, 339, 435
- Restatement of accounts on basis of, 342, 344, 435
- Revisions of accounts on basis of, 342-3, 435

Value of public service plants,

- Accounts, difficulty of including, 119, 337-9, 343, 435 (See also "Fixed capital: accounting for")
- Manipulation responsible for abuses of capitalization, 337
- Definition, absence of agreement as to a satisfactory, 433-34
- Earning power as basis of, 337-8
- Original cost as basis of, 337
- Realized on sale at foreclosure, 183
- Real, not obtainable, 119, 168
 - Open markets, absence of, 168-70
 - Operation and use necessary to give, 169-70
- Reproduction cost as basis of, 339
- Sale, restrictions on, affecting, 168
- Success of enterprise controlling, 169-70
- Test of, 339, 434

Voting rights,

- Alienation from ownership of capital stock forbidden, 85
 - Harmful results of permitting, 85-6
 - Statutory misdemeanor, 85
 - Voting trust, exception in case of (See "Voting trust")
- Bribe, exercise of, under, 86-7
- Classification solely as to, unusual, 104
 - Instance of common stock so classified, 98
- Exercised in corporate welfare, 86-7
- Sale of, not permitted, 85-6

Voting trust,

- Agreement of, provision in statute, 88
- Certificate of, issued to participants in, 88
- Dividends on stock held in, 88
- Distinguished from deposit of stock with proxy, 89
- Term limited, 88
- Purpose of obtaining concerted action, 88
 - Object must be legal, 88
- Trustees under, 88

W**Watered stock,**

- Aspects of sometimes considered defensible, 66-8 (See also "Discount: stock sold at")
- Definition, 58
- Financing through construction companies as means of, 387-8
- Forms in which appearing, 58-9
- Issue for property, labor, and services, as means of, 59 (See also "Consideration realized on issue of securities")
- Publicity of facts concerning issue of stock as remedy, 61-2
 - Basis of English legislation, 63-4, 69
 - Limitation on utility of, 65
- Rates and service, supposed effects, 61, 64-5
- Regulation by commissions as effective remedy, 65-6
 - Supposed inadequacy of, 68-9
- Statutory restraints on,
 - Aim of, 61-2
 - Devices used in European countries, 62-4
 - Laxity in enforcement of, reason for, 66
 - Legislation in United States, 66

Watered stock—Continued

Stock of railroad corporations alleged to represent, 252

Suspending negotiability of vendors' shares, France, 62

Wharf bonds, 188**Working capital,**

Capitalization to provide for beginning operations, 392-3, 439

For maintenance of service, when allowed, 392, 438-40

**UNIVERSITY OF CALIFORNIA LIBRARY
BERKELEY**

**Return to desk from which borrowed.
This book is DUE on the last date stamped below.**

6 Jun 1960 W

LD 21-100m-11,'49(B7146s16)476

